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Progress towards Meeting the Economic Criteria for EU Accession

The EU Commission's 2018 Assessments

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EUROPEAN ECONOMY

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European Commission
Directorate-General for Economic and Financial Affairs

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Institutional Paper 080

ABBREVIATIONS

BiH	Bosnia and Herzegovina
CEFTA	Central European Free Trade Agreement
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
ERP	Economic Reform Programme
EU	European Union
EUR	Euro
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
fYRoM	The former Yugoslav Republic of Macedonia
GDP	Gross Domestic Product
IDF	Investment Development Fund
IFIs	International Financial Institutions
ILO	International Labour Organization
IMF	International Monetary Fund
LFPR	Labour Force Participation Rate
LFS	Labour Force Survey
NPLs	Non-performing loans
OECD	Organisation for Economic Co-operation and Development
PISA	Programme for International Student Assessment
PRB	Procurement Review Body
RS	Republika Srpska
SAA	Stabilisation and Association Agreement
SBA	Stand-by Arrangement
SMEs	Small and Medium sized Enterprises
SOEs	State-Owned Enterprises
UNSCR 1244	United Nations Security Council Resolution 1244

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* This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ opinion on the Kosovo declaration of independence.

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INTRODUCTION

In this Institutional Paper the Directorate General for Economic and Financial Affairs brings together into a single document the economic chapters of the European Commission's country reports for the seven enlargement countries Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Kosovo[(*)], Montenegro, Serbia and Turkey. The reports assess progress achieved in each of the countries since the adoption of the last package, embedded in a broader assessment of trends over a 3 to 5-year horizon, with a view to advancing necessary political and economic reforms as well as legal transformation in line with the EU accession criteria. The European Commission adopted the country reports on 17 April 2018 as part of its 2018 Enlargement Package.

This introduction explains the methodology underlying these reports that the Commission has been following since 1997 in order to carry out these assessments.

The purpose of this Institutional Paper is to facilitate the work of those scholars, researchers and analysts of the enlargement process, who are mainly interested in the economic aspects. As such, it represents only a part of the overall progress made by the enlargement countries towards meeting the accession criteria. A proper full-fledged assessment of progress made under all examined aspects can be found in the 2018 reports, i.e. the Commission staff working documents for each of the countries.

The conclusions of the assessments in the economic chapters, summarising the state of compliance with the Copenhagen economic criteria, are provided at the end of each country section in this publication.

The methodology of the reports

In 1993, the Copenhagen European Council identified the economic and political requirements candidate countries will need to fulfil to join the EU. It also concluded that accession could take place as soon as they were capable of fulfilling them.

The criteria are:

- the political criteria - stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;

- the economic criteria - the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union;

- the institutional criteria - the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union, which includes the whole range of policies and measures that constitute the acquis of the Union. Candidate countries must adopt, implement and enforce the acquis. This requires the administrative capacity to transpose European Community legislation into national legislation, to implement it and to effectively enforce it through appropriate administrative and judicial structures.

The European Commission first assessed progress made by the then candidate countries with respect to these criteria in the 1997 Opinions. Thereafter, the Commission, at the request of the Council, submitted annual Country Reports to the Council assessing the further progress achieved by each country on their fulfilment. These reports have served as one of the elements for the Council to take decisions on the conduct of negotiations and on the definition of the pre-accession strategy. Since 2005, also the potential candidate countries are assessed according to the same format and methodology.

The economic sub-criteria

Regarding the economic criteria, the Commission applies a set of sub-criteria to examine the progress achieved during each year. The compliance with the functioning market economy criterion is thus evaluated against the following five sub-criteria:

– high quality of economic governance

– achieved macroeconomic stability (including adequate price stability and sustainable public finances and external accounts);

– proper functioning of the goods and services market (including business environment, state influence on product markets, and privatisation and restructuring);

– proper functioning of the financial market (including financial stability and access to finance);

– proper functioning of the labour market;

The capacity to withstand competitive pressure and market forces within the Union is assessed on the basis of the following four sub-criteria:

– a sufficient amount, at appropriate costs, of human capital, education, research, innovation, and future developments in this field;

– a sufficient amount and quality, at appropriate costs, of physical capital and infrastructure;

– changes in the sector and enterprise structure in the economy, including the role of SMEs;

– the degree and the pace of the economic integration with the Union, and price competitiveness;

It is important to note that these conditions do not serve as a simple checklist. First, the interplay and interaction of all conditions, and their mutually reinforcing effects on the economy, are pertinent. Second, there is an important time dimension involved. Meeting the economic criteria requires deep and lasting structural reforms that take time to be accomplished. The issue of track record becomes then very relevant. In this context, the concept of track record means the irreversible, sustained and verifiable implementation of reforms and policies for a long enough period to allow for a permanent change in the expectations and behaviour of economic agents and for judging that achievements will be lasting.

1. ALBANIA

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. Each enlargement country prepares an Economic Reform Programme (ERP) annually, which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Albania has made **some progress** and is **moderately prepared** in developing a functioning market economy. The public debt-to-GDP ratio and the current account deficit were reduced. Economic growth increased further and unemployment decreased but is still high. Non-performing loans (NPLs) in the banking sector have been reduced, but bank lending to businesses remains sluggish. Reforms crucial to improving the business environment progressed but require further efforts. The comprehensive judicial reform advanced but needs to be fully implemented. The new bankruptcy law entered into force and should strengthen the insolvency regime. However, business-relevant regulations remained cumbersome and shortcomings in the rule of law continued to hamper businesses and deter investments.

To support long-term growth, Albania should pay particular attention to:

→ continue fiscal consolidation to meet the medium-term target for public debt reduction and create more room for manoeuvre for fiscal policy;

→ bolster financial stability further by continuing to promote the resolution of NPLs and the use of the domestic currency;

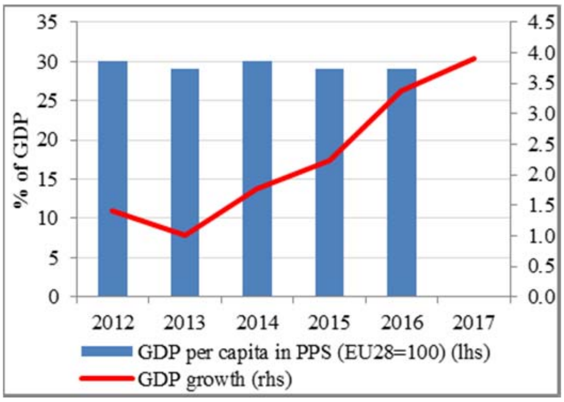
→ reduce the informal economy, including undeclared work.

Economic governance

Albania continued to strengthen its macroeconomic stability and implement market-oriented reforms. Addressing the high level of public debt remained the focus of fiscal policy, although the pace of consolidation has slowed down. The fiscal rules, adopted with an amendment to the Organic Budget Law in June 2016, have been complied with. Ambitious finance management reforms are under way with EU budget support. A fiscal risks unit has been established in the Ministry of Finance and first efforts have been made to identify such risks. The stipulated procedure for adopting the 2018 budget was not fully respected which impaired parliamentary discussions. Stability and growth have been bolstered by the three-year programme with the International Monetary Fund (IMF) completed in February 2017. Reforms crucial to improving the business environment advanced but require further efforts. The policy guidance jointly adopted in May 2017 has been partially implemented.

Macroeconomic stability

Figure 1.1. Albania GDP growth



Source: Eurostat, national sources

The Albanian economy has continued to expand thanks to both domestic demand and foreign trade. Annual GDP growth in real terms increased from 3.4 % in 2016 to 3.9 % in the first three quarters of 2017. All components of domestic demand have contributed positively to output expansion. Capital spending has been the main driver, benefitting from large foreign direct investment (FDI) in the energy sector. Private and public consumption have also recovered over the past 2 years. Net exports added to GDP growth between mid-2016 and mid-2017 based on very strong services export (including tourism) and a recovery of goods export. Despite stronger economic activity, per capita GDP in purchasing power standards stood at only 29 % of the EU-28 average in 2016, practically unchanged since 2009.

The substantial current account deficit has narrowed and been more than covered by FDI inflows. Albania has historically run a large trade deficit partly funded by remittances from Albanians living abroad. Since 2015, the current account balance has been improving, cutting the deficit as a percentage of GDP from 10.8 % in 2014 to 6.3 % in the 12 months to the end of September 2017. This has exclusively been the result of a sharply higher surplus on the balance for services trade, while the trade deficit for goods has remained very high. Revenues from foreign tourism increased strongly in 2016 and 2017, but the contribution from other services (which include manufacturing services) was even greater. Remittances remained relatively stable in absolute terms, but their share of GDP fell to 5.5 %. FDI inflows, recently mainly associated with the construction of the Trans Adriatic Pipeline and a large hydropower project, amounted to 8.0 % of GDP in the year to the end of September 2017. As in 2016, they thereby exceeded the current account deficit. The gross external debt-to-GDP ratio declined to 67.9 % at the end of September 2017. Foreign exchange reserves have remained stable over the past 2 years at close to 25 % of GDP. They cover 6-1/2 months of imports of goods and services, providing an adequate safeguard against adverse shocks.

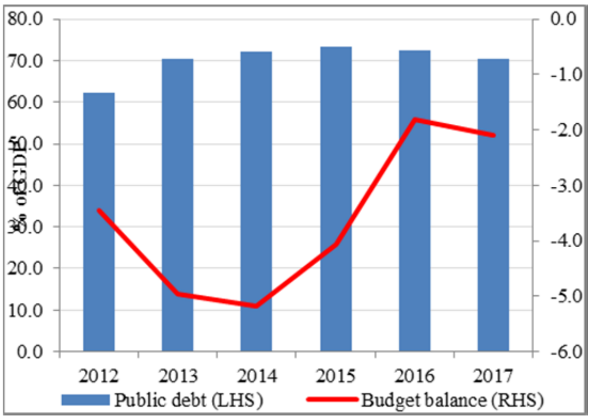
Table 1.1: **Albania - Main economic trends**

		2012	2013	2014	2015	2016	2017
Gross domestic product	Ann. % ch	1.4	1.0	1.8	2.2	3.4	3.8
Private consumption	Ann. % ch	0.1	1.8	2.8	1.2	2.7	2.8
Gross fixed capital formation	Ann. % ch	-7.9	-2.0	-4.5	3.5	3.3	7.7
Unemployment rate	%	13.8	16.4	17.9	17.5	15.6	14.1
Employment	Ann. % ch	1.2	-9.7	1.6	4.9	6.1	2.7
Wages, public sector	Ann. % ch	7.3	4.1	1.7	1.8	0.9	9.8
Current account balance	% of GDP	-10.2	-9.3	-10.8	-8.6	-7.6	-6.9
Direct investment (FDI, net)	% of GDP	6.8	9.6	8.2	8.0	8.7	8.4
CPI, average	Ann. % ch	2.0	1.9	1.6	1.9	1.3	2.0
Exchange rate LEK/EUR	Value	139.04	140.26	140.14	139.74	137.36	134.14
General government balance	% of GDP	-3.4	-5.2	-5.2	-4.1	-1.8	-2.0
General government debt	% of GDP	62.1	65.6	70.1	72.7	72.3	70.1

Source: Macrobond, Eurostat

Inflation remained below the official target but prompted no further monetary easing. Average annual inflation has been below the central bank's 3 % target since 2012, falling to 1.3 % in 2016. A weather-related spike in food prices in the winter of 2016-2017 raised annual average inflation to 2.0 % in 2017, but underlying price pressures have remained subdued helped by a strong lek in foreign exchange markets. The Bank of Albania has maintained a very accommodative monetary policy by keeping the key policy rate (the repo rate) at the record low of 1.25 % since May 2016. The freely floating exchange rate of the lek appreciated 1.7 % against the euro over 2017 and 5.6 % since June 2015.

Figure 1.2. Albania fiscal developments



Source: Eurostat, national sources

The government's fiscal deficit has been more than halved since 2015. The general government's overall deficit corresponded to 1.8 % of GDP in 2016, down from 4.1 % in the previous year. Most of the deficit narrowing was due to the government completing the repayment of old arrears in 2015, thus eliminating an important expenditure item. But higher tax revenues also contributed significantly to the lower deficit, although they remained below budgetary projections. The realised fiscal deficit was nevertheless 0.4 percentage points below the original target as a result of a significant under-execution of expenditures.

The 2017 budget has a deficit target of 2.0 % of GDP and the preliminary data on budget realisation suggest that the target has been met. The budget was amended twice to take into account drought-related emergency support to the electricity sector and a government reorganisation. The revisions raised planned revenues and expenditures by a similar, relatively modest rate and left the budget target unchanged. The fiscal rule banning overspending in election years was complied with.

The public debt-to-GDP ratio has declined, but further consolidation is required to achieve the medium-term fiscal target. The public debt-to-GDP ratio started to decline in 2016 after having risen significantly in the previous 5 years. The government estimates that the debt ratio fell further to 69.9 % at the end of 2017. The current fiscal framework operates with a medium-term debt objective of 45 % of GDP and annual budget balances that ensure a falling debt ratio until the target is reached. Within this framework, the current government has committed to reduce the debt ratio to below 60 % by 2021. This would probably require additional consolidation efforts compared to current fiscal plans.

Albania's level of public debt remains high compared with regional peers and is associated with risks to macroeconomic stability in case of adverse shocks. In recent years, the authorities have been able to lengthen the average maturity of the public debt stock significantly and to shift it increasingly towards external creditors. Almost half of the debt is now denominated in foreign currencies, most of which in euros. The shifting debt composition means that the rollover risk has been lowered, but interest rate and exchange rate risks have increased. Just over half of the public debt is still held domestically, mainly by the banking sector, and much of it is still short-term and has to be refinanced frequently.

The macroeconomic policy mix was appropriate. Fiscal policy was prudent in 2017 despite it being an election year, but further reducing the budget deficit during the current economic upturn is necessary to make public debt more sustainable. Fiscal consolidation also reduces public borrowing, providing space for increased lending to the private sector, particularly for investment. Keeping the key interest rate low is appropriate as it helps to raise weak inflation and support economic activity.

The functioning of product markets

Business environment

In spite of new legislation and other measures, the business environment remains a constraint on Albania's competitiveness and growth performance. The new bankruptcy law entered into force in May 2017 and should strengthen the insolvency regime, streamline burdensome market exit procedures, prevent abuse and facilitate collateral recovery. However, its implementation still awaits the adoption of regulations, especially on insolvency administrators, and out-of-court restructuring still needs to be facilitated. The Private Bailiffs Law has also been amended to protect the rights of lenders and strengthen the enforcement of loan collateral, but the bylaw to fully implement the reform still needs to be revised. Procedures for business registration, licensing and building permits have been improved. Reforms in the electricity sector have improved its finances, but getting electricity remains lengthy, complicated and costly for users. Redundant regulatory and procedural hurdles constitute another significant impediment for business. Access to formal finance, especially in the start-up phase, remained a challenge for firms.

Shortcomings in the rule of law continued to hamper the business environment, although the justice reform advanced. In spite of measures taken to address the informal economy, it is estimated to account for at least one third of GDP. This is causing tax revenue losses, a lack of labour protection and unfair competition among firms. Ineffective contract enforcement, uncertain property rights and the prevalence of corruption are major concerns repeatedly expressed by businesses. Progress on judicial reform needs to be translated into a more favourable business environment. Better governance, a more predictable tax system, consistent enforcement of rules, and more efficient delivery of public services would substantially improve the business environment.

State influence on product markets

State presence and public subsidies remained limited in the Albanian economy with the notable exception of the electricity sector. The share of public revenue and spending in GDP remained relatively low. Total reported State aid stood at 0.15 % of GDP in 2016, mainly in the form of horizontal aid in the area of training, research and development, employment, culture and support to small and medium-sized enterprises. Reform in the electricity sector has substantially decreased distribution losses, improved bill collection rates and strengthened the financial situation of state-owned enterprises in the sector. Although budget allocations to the energy sector had originally been reduced significantly in 2017, a drought and a difficult financing situation obliged the government to provide a substantial loan to the sector in August, requiring a budget revision. The government has expressed its intention to eliminate all power sector subsidies, including public guarantees and policy net lending, by 2020.

Privatisation and restructuring

Albania is well advanced in market liberalisation and privatisation. The private sector remained dominant in the economy, providing about 84 % of all jobs. The state's involvement in the economy remained limited and was concentrated in public utilities (railways, electricity, water and oil extraction). Albania has moved ahead with separating the production of gas and electricity from transmission and distribution. Shortcomings remained in the corporate governance of state-owned electricity companies. Further liberalisation of the electricity market would enable private operators to enter the market, thereby increasing competition and quality of supply. An action plan for the privatisation or liquidation of state companies in non-strategic sectors was adopted in March 2017.

The functioning of the financial market

Financial stability

The stability of the banking system improved as the number of NPLs was reduced. Albania's banks are generally well capitalised, with a capital adequacy ratio which rose over the course of 2017 and is well above the regulatory minimum. The banking sector's liquidity ratios also remain well above the minimum regulatory levels. Deposits remain the main source of funding, covering almost twice the volume of total bank loans. The ratio of NPLs to total loans declined to 13.2 % at the end of 2017, 5.1 percentage points (pps) lower than a year earlier, mainly as a result of mandatory write-offs.

Banking sector profitability improved in 2017. The sector's financial result more than doubled in the first half of the year on a year-on-year basis. Return on assets and equity stood at 1.5 % and 15.7 %, respectively, in December 2017, more than double their levels a year earlier. However, use of the euro for loans has remained high: foreign currency loans to unhedged borrowers still account for around one quarter of total private sector credit, making their repayment vulnerable to a depreciation of the domestic currency. Government securities represent almost a quarter of bank assets, exposing banks to sovereign risk as well.

Access to finance

There is scope for banks to expand lending and better support the economic recovery. The banking sector, dominated by foreign banks, holds over 90 % of all financial system assets. With loans to businesses and households amounting to about 37 % of GDP, there is much scope for increased bank lending. However, credit to the business sector has stagnated in recent years despite low interest rates as a result of both low demand for and tight supply of bank loans. With the ratio of NPLs declining, lending to the business sector recorded slightly positive growth in the third quarter of 2017 when adjusted for loan write-offs.

The non-banking financial sector remained relatively small. It includes insurance companies, savings and loan associations, private supplementary pension funds, investment funds, and some other non-banking financial institutions. Their total assets corresponded to close to 10 % of total financial sector assets in 2017, little changed from the preceding 2 years but up from 6.6 % in 2012. The capital market is rudimentary and the stock exchange remained closed. There is significant scope for expanding equity and corporate bond finance provided the supervision capacity is strengthened and transparency and governance in the private sector is improved.

The functioning of the labour market

Stronger economic activity improved labour market conditions, but unemployment remained high. The economic upswing continued to create new jobs in 2017, but at a lower rate than in the preceding year. In the first three quarters, employment in the 15-64 age group increased by a relatively modest 2.5 % compared with a year earlier. This allowed the unemployment rate to decline to 14.3 % from 16.0 % in the corresponding period in 2016. The youth unemployment rate (covering the 15-29 age group) fell from 29.2 % to 26.3 %. In addition to substantial skill mismatches, persistently high unemployment reflects rigidities in labour market legislation and lack of incentives to work.

Labour force participation - the number of people employed or looking for work - continued to rise, possibly reflecting improved employment prospects. Two thirds of the working age population were now employed or looking for a job. However, the gap between the male and female participation rates widened significantly. 42 % of the workforce was employed in agriculture, mostly in low-skilled and low-productivity jobs, and informal employment remained widespread. Active labour market policies have continued to be implemented, but they still covered only 5.5% of the unemployed in 2017 which, however, was an increase from previous years. The end of the public wages freeze in March 2017 drove up average public sector wages by about 11%.

Figure 1.3. Unemployment in Albania (% of Active population)

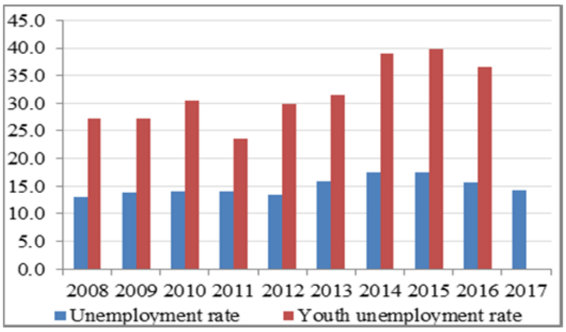
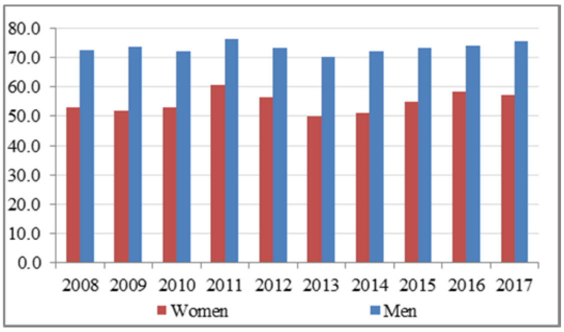


Figure 1.4. Participation rates in Albania (% of Labour Force)



Source: Eurostat, national sources

1.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Albania has made **some progress** and has **some level of preparation** in terms of capacity to cope with competitive pressure and market forces within the EU. Specifically, progress was made on energy and transport infrastructure and digitalisation, although shortcomings remain which hinder Albania's competitiveness and trade. The quality of education needs to be raised at all levels, not least to better equip people with skills that the labour market needs. Foreign trade remains below potential and sectorally concentrated. Albania's capacity for research, development and innovation remains low.

To support long-term growth, in the coming year Albania should pay particular attention to:

→ improve the quality of the education system, including increasing capacity;

→ develop the capacity for technological absorption, research, development and innovation;

→ enhance public investment in infrastructure in a transparent and fiscally responsible way.

Education and innovation

The quality of Albania's education system is relatively poor. Compared to 2012, Albania improved its scoring in the OECD's 2015 PISA assessment of the performance of 15-year-old students in science, reading and mathematics, but the overall ranking remained below all EU Member States. Public spending on education remains low. Total expenditures from the state budget for vocational education and training have increased, but still accounted for only 0.13 % of GDP in 2017. Particularly in remote rural areas, school infrastructure and the quality of teachers are inadequate. The World Bank reports a functional illiteracy rate above 50 %. The level of funds available for teacher training in all fields of education is insufficient. Reforms in higher education and science have continued but further improvements are needed. The total number of teachers in the pre-university education system in 2016-2017 was 2 % lower than a year earlier.

The capacity for technological absorption, research, development and innovation remains low. The Education Ministry's budget for research and development has remained very modest. Some State aid was granted in 2016 for research and innovation. Substantial efforts to strengthen the link between business and academic and research institutions are needed. Upgrading the economy from low-technology, labour-intensive and low-cost production areas requires more research and innovation. This is particularly the case in sectors like agriculture & food, energy, and sustainable tourism which are crucial for Albania's economic development. Statistical data on research and development needs to be improved.

Physical capital and quality of infrastructure

The level of investment has stabilised but remains dependent on foreign inflows. Investment has accounted for one quarter of GDP in recent years, much of it by foreign companies. In 2017, when the construction of hydro power plants on the river Devoll and the Trans Adriatic Pipeline reached their peak, FDI inflows amounted to about 8 % of GDP. A fully functioning cadastre is not yet in place; together with uncertainties about land ownership, this is a significant impediment to investment. Large investments are often delayed by lengthy land expropriation procedures, which in most cases require a proper registration of the rightful owners first. Public investment, amounting to 4-5 % of GDP in recent years, has often been hampered by weaknesses in public investment management.

Albania's transport and energy infrastructure made some progress but is still insufficiently developed. Improvements to the road network continued and a new railway law was adopted in early 2017. However, better connections to neighbouring countries and the EU transport network still need to be established to reduce transportation costs and facilitate trade. There has been some progress on energy infrastructure, but inadequate the electricity supply remains a key structural challenge that increases costs to businesses.

The digitalisation of the economy is gradually being developed. Major advances have been the establishment of online platforms for business registration, licensing, tax filing, e-banking, e-commerce, e-signature, mobile payment of bills, and issuance of civil registry-related certificates. Broadband coverage and users have increased.

Sectoral and enterprise structure

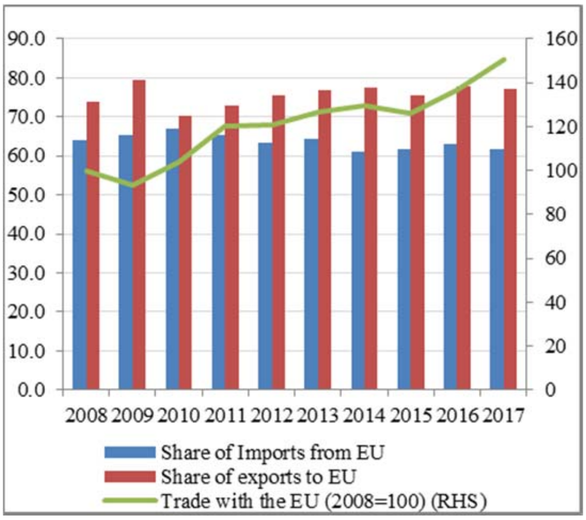
The Albanian economy is led by the services sector, but agriculture still retains an important role. In 2016, services again increased their share of gross value added (to 53.2 %). Agriculture remained the second most important sector (at 22.9 %). Industry (13.3 %) has gradually increased its share of the economy over the past 10 years, mainly as a result of rising crude oil production. Within industry, manufacturing is relatively small (6.4 %) and mainly produces low value added and labour-intensive products such as textiles and footwear. Construction (10.5 %) has seen its share of the economy decline sharply over the past 10 years.

Exports continue to be concentrated in a few sectors. 76.0 % of goods exports in the first eight months of 2017 came from three product categories: textiles and footwear (43.6 %); minerals, fuel and electricity (16.6 %); and construction materials and metals (15.9 %). This lack of diversification contributes to the large external deficit and exposes the economy to industry-specific shocks like sharp swings in energy prices.

SMEs play a significant role in the economy. SMEs provide 80 % of employment and two thirds of value added in the non-agricultural private sector. Various state- and donor-funded schemes support SMEs' competitiveness. However, further steps need to be taken to strengthen their innovation capacity and improve their access to finance, such as developing the venture capital market.

Economic integration with the EU and price competitiveness

Figure 1.5. Albania trade integration with the EU



Source: Eurostat, national sources

The EU is Albania's dominant trading partner, but overall trade remains below potential. Albania's total foreign trade (exports and imports combined) increased from 72.1 % of GDP in 2015 to 74.8 % in 2016. A better integration into global supply chains would help boost productivity and create more and better jobs. The EU accounted for 76.6 % of Albania's goods exports and 61.3 % of its goods imports in the first 8 months of 2017. Within the EU, Italy is the main destination for Albanian exports, absorbing more than half of Albanian goods sold abroad and providing almost 30 % of imported goods. The EU remains the main source of FDI into Albania and held 57.6 % of the total stock of such investment at the end of September 2017.

Trade links with Central European Free Trade Agreement (CEFTA) countries are also relatively significant, mainly on account of exchanges with Kosovo. Taken together, Albania's six CEFTA partners accounted for about 15 % of Albanian goods exports and 7.5 % of its goods imports in 2017. These shares are largely unchanged since 2008, suggesting a large untapped potential for future growth, if intra-regional connectivity improves and some technical barriers to trade are eliminated. The development of a Regional Economic Area based on EU rules and standards, to which all Western Balkan economies have committed, has the potential to generate untapped growth.

Regarding price and cost competitiveness, the real effective exchange rate was 4.2 % higher than a year earlier at the end of 2017.

1.3. CONCLUSIONS

As regards the economic criteria, Albania has made some progress and is moderately prepared in developing a functioning market economy. The public debt-to-GDP ratio and the current account deficit have been reduced. Economic growth increased further and unemployment decreased but is still high. Non-performing loans (NPLs) in the banking sector have been reduced, but bank lending to businesses remains sluggish. Reforms crucial to improving the business environment progressed but require further efforts, including the reduction of the informal economy. The comprehensive judicial reform advanced but needs to be fully implemented. The new bankruptcy law entered into force and should strengthen the insolvency regime. However, business-relevant regulations remained cumbersome and shortcomings in the rule of law continued to hamper businesses and deter investments.

Albania has made some progress and has some level of preparation in terms of capacity to cope with competitive pressure and market forces within the EU. Specifically, progress was made on energy and transport infrastructure and digitalisation, although shortcomings remain which hinder Albania's competitiveness and trade. The quality of education needs to be raised at all levels, not least to better equip people with skills that the labour market needs. Foreign trade remains below potential and sectorally concentrated. Albania's capacity for research, development and innovation remains low.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the EU.

The monitoring of these economic criteria should also be seen in the context of the increased importance of economic governance in the enlargement process. In 2017, enlargement countries were again asked to prepare Economic Reform Programmes (ERPs), which set out a medium-term macro-fiscal policy framework together with key structural reforms. The ERPs are the basis for country-specific recommendations jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

The former Yugoslav Republic of Macedonia has made **some progress** and is at a **good level of preparation** in developing a functioning market economy. Despite the political stalemate in the first half of the year, noteworthy improvements took place, in particular in public finance management and transparency. Key weaknesses of the economy remain. These include shortcomings in the business environment, such as weak contract enforcement and a large informal economy. Structural problems of the labour market are reflected in low activity and high unemployment rates. The macroeconomic environment deteriorated in the first half of 2017, as the lengthy political crisis took a toll on investment. Fiscal policy is geared towards short-term measures and lacks a durable consolidation plan.

In order to support long-term growth, the former Yugoslav Republic of Macedonia should pay particular attention to:

→ developing a medium-term budget framework and pursuing fiscal consolidation including by better targeting of transfer spending.

→ improving contract enforcement and reducing informality.

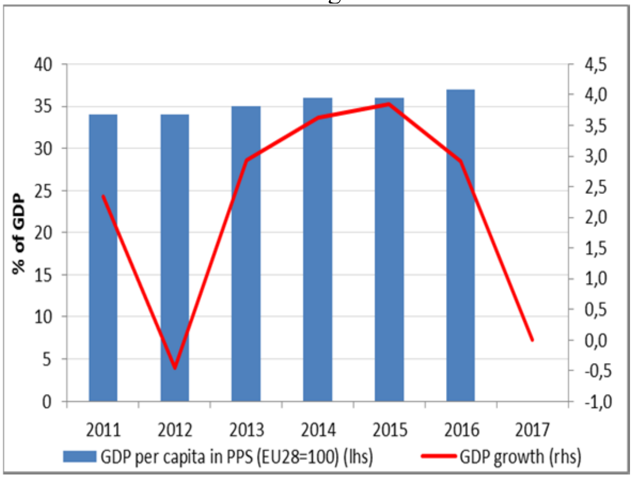
→ enhancing labour market participation and employment, especially for women and youth.

Economic governance

The government remains committed to market-based economic policies even though it is now embarking on fiscal stimuli to subsidise investment and employment. Economic policy continued to focus on export growth through (i) foreign direct investment; (ii) raising private sector competitiveness through public infrastructure spending, and (iii) boosting employment through active labour market policies and employer subsidies. The new government, which came to power in June 2017, remains committed to these three policy pillars. It is also redesigning a number of them to improve their effectiveness. In particular, the government plans to increase subsidies for investment and employment in the private sector, and to apply a "same subsidy" policy to foreign and domestic companies alike. It also intends to expand the range and coverage of active labour market policies, and social transfers. It has raised minimum wages. Moreover, the government has started to improve the efficiency of public administration and the judiciary, fight corruption, and increase transparency in public finance. The policy guidance jointly adopted in May 2017 has been partially implemented.

Macroeconomic stability

Figure 2.1. The former Yugoslav Republic of Macedonia: GDP growth



Source: Eurostat, national sources

The extended political crisis took a toll on investment and growth. The economy did not grow in 2017, according to a first estimate from the national statistical office. Exports provided stimulus to the economy, increasing by 9.2%, but their effect was more than offset by the decline in investment and public consumption. Investment spending fell by 4.5% compared to one year earlier, impacted by a decline in confidence resulting from the prolonged political crisis. In particular, the construction sector, which was the fastest growing industry in the preceding 6 years, slumped in 2017. Household consumption, however, continued to increase at a solid pace of nearly 3%. The growth outlook is positive, as the political crisis has abated and economic fundamentals remain sound. Monetary policy remains accommodative. Convergence with EU income levels remains sluggish. Real GDP per capita has increased from 34% of the EU-28 average in 2012 to 37% in 2016.

Table 2.1: **The former Yugoslav Republic of Macedonia - Main economic trends***

		2012	2013	2014	2015	2016	2017
Gross domestic product	Ann. % ch	-0.5	2.9	3.6	3.8	2.9	0.0
Private consumption	Ann. % ch	1.2	1.9	2.2	4.4	3.1	2.9
Gross fixed capital formation	Ann. % ch	21.2	0.5	10.7	8.3	13.3	-4.5
Unemployment rate	%	31.0	29.0	28.2	26.3	24.0	22.4
Employment	Ann. % ch	0.8	4.3	1.0	1.7	2.4	2.7
Wages	Ann. % ch	0.2	1.2	1.0	2.7	2.0	2.6
Current account balance**	% of GDP	-3.2	-1.6	-0.5	-2.0	-2.7	-1.3
Direct investment (FDI, net)**	% of GDP	1.7	7.9	2.8	2.2	3.3	2.3
CPI, average	Ann. % ch	3.3	2.8	-0.3	-0.3	-0.3	1.4
Exchange rate MKD/EUR	Value	61.53	61.58	61.62	61.61	61.60	61.57
General government balance	% of GDP	-3.8	-3.8	-4.2	-3.5	-2.7	-2.7
General government debt	% of GDP	33.7	34.0	38.1	38.1	39.5	39.3

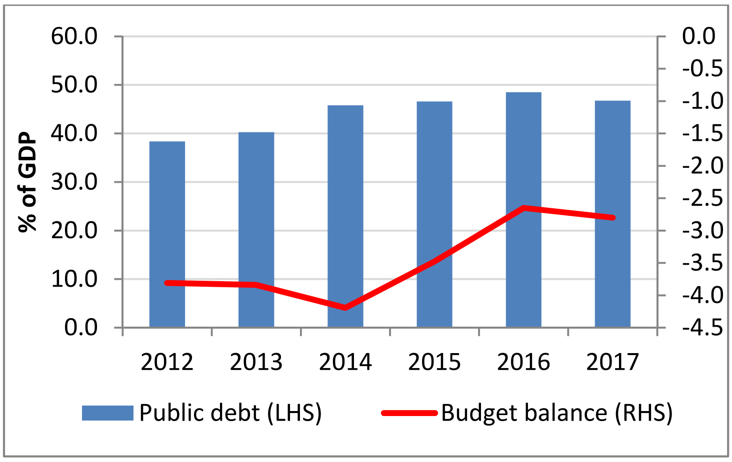
*This table reflects the most recent data available which might differ from the ones in the text.
** refers to a 4 quarters moving average.
Source: Macrobond, Eurostat.

Dynamic exports bolster the external position, and vulnerabilities remain contained. The current account deficit has remained moderate in recent years. In 2017, it stood at 1.3% of estimated GDP, down from 2.7% in 2016. This development was due to the continued improvement in the trade balance, in spite of a decline in private transfers from abroad. Inflows from foreign direct investment (FDI) decreased in 2017, compared to the previous year, amounting to 2.3% of estimated GDP. External debt has been rising rapidly between 2009 and 2017 (+20pps), as a result of public sector financing abroad and rising cross-border intercompany liabilities. At the end of September 2017, it stood at some 75% of GDP, about one quarter of which is short-term, unchanged from previous years. Foreign exchange reserves dropped in

2017, as the government repaid sizeable external loans, yet their import coverage remained satisfactory at about 4-5 months. In January 2018, reserves were temporarily replenished through the issuance of a EUR 500 million Eurobond. At the same time, the government lowered its high upcoming refinancing needs by a partial early redemption of the 2015 Eurobond.

The monetary policy stance remained appropriate, and supported price stability and the currency peg. In 2016, consumer prices declined for the third year in a row. Inflation picked up in 2017 (+1.4% on average compared to 2016), driven in particular by secondary effects of recent fuel price increases, and by rising wages in the services sectors. Commercial bank deposits rose again after a temporary, speculation-induced drawdown in spring 2016, and foreign currency markets stabilised. This prompted the central bank to lower the key interest rate by 75bps in three consecutive steps between December 2016 and February 2017 back to the level prevailing before the tightening of May 2016 (3.25%). The bank effectively stimulated the "denarisation" of loans and deposits, with the share of loans in foreign currency falling to 19% of total loans, compared to 21% one year earlier. Still, the high level of unofficial "Euroisation" remains a risk to financial stability and poses a challenge to monetary policy. Given the subdued price developments, sluggish corporate lending, and a negative output gap, the current stance of monetary policy seems in line with economic fundamentals.

Figure 2.2. The former Yugoslav Republic of Macedonia: fiscal developments



Source: Eurostat, national sources

Sustainable fiscal consolidation measures are needed. In 2017, the general government fiscal deficit remained at about pre-year level (2.8% of estimated GDP). In the preceding two years, it had narrowed consecutively, but largely as a result of underexecuted capital expenditure and reduced spending on goods and services. Each year, the government resorted to a budget rebalancing. This was because revenue (in particular VAT collection) remained under target, and financing of the rapidly increasing expenditure on pensions and other transfers, which makes up over 60% of total expenditure, could not be secured. The 2018 budget foresees a significant fiscal stimulus, including higher pensions and subsidies, and funds to cushion the rise in minimum wages, and the extension of employment measures. However, the government has not presented consolidating measures to offset this rise in current expenditure. Public debt, which had been increasing continuously since 2009, stood at 46.7% of GDP at end-2017, which is nearly 2 percentage points lower than a year earlier. This came as a result of both, a decline in public enterprise debt, and lower general government debt, which dropped by 0.3pp to 39.3% of GDP.

The government is committed to improving the transparency and management of public finances. Public information on the fiscal situation in terms of extent and quality of data and timeliness has been enhanced noticeably since the new government took up office. In late summer 2017, it published a first compilation of unpaid public sector liabilities, and is working on a clearance strategy. It published a "Citizens' Budget" for 2017 and 2018, and started reimbursing blocked VAT refunds to the private sector. Covering a number of issues highlighted in respective reports from international organisations, the government adopted a Public Financial Management Reform Programme in December 2017, which contains plans for the introduction of fiscal rules by 2019 and the establishment of a fiscal council.

The success of the current policy mix depends critically on structural reforms. The expansive fiscal stance, accompanied by accommodative monetary policy, is largely suitable for the current economic environment. However, it carries risks to fiscal sustainability, long-term economic growth and external stability. These risks can be mitigated through increased competitiveness of labour and product markets. To that end, structural reforms need to play a bigger role, and be better integrated in the economy's growth model. The government should support, in particular, public infrastructure as well as private corporate investment, and human capital skills development. Fiscal consolidation must be pursued with sustainable measures.

Product markets

Business environment and market institutions

Contract enforcement remains problematic but the government is taking steps to improve it. Institutional capacity to enforce the law remains weak, and resolving a commercial dispute through a court is time-consuming and costly. In recent years, the legal infrastructure has been improved and the number of cases handled by the courts has gone up. However, political interference with the courts frequently led to inefficient outcomes and has undermined trust. The new government is committed to increasing the effectiveness and the impartiality of the legal system, and has adopted measures to achieve this (such as the "3-6-9 Plan"). Non-transparent inspections and para-fiscal fees remain an issue.

The shadow economy remains a large obstacle to business. The informal share of the economy remains large, impacting on the competitiveness of the formal private sector, although it is declining in terms of gross value added and employment. In surveys, the informal economy is consistently referred to as an obstacle to doing business in the country. Estimates on its size range from some 20% of total output (State Statistical Office) to about 40%, depending on the method applied. This creates obstacles to investment and serious problems of competition for registered companies.

State influence on the product market

The public sector's share in the economy remains limited, and the new government is committed to fair and equal treatment of private companies. In 2016 (latest available figure), the number of companies in which the government held a stake declined compared to the previous year. Full state ownership in 2016 was kept in 16 companies, the same as one year earlier. As a result, the value of state assets as a percentage of GDP dropped by 1.5pps to 11.7%. However, throughout most of the reporting period, the government continued to be involved in the private sector through uneven application of rules and regulations, inspections, public procurement procedures and state aid. This often imposed great costs on private enterprises. The new government seems committed to transparent and equal enforcement of rules in the private sector. It also plans to extend subsidies to foreign and domestic companies on equal terms. There was little information published during the reporting period on amounts and beneficiaries of state aid and ex post evaluations. The large share of state-owned land remains an obstacle to the development of the agricultural sector, and restricts its use as collateral by private owners seeking a bank loan. The governance of SOEs remains short of internationally-agreed good practice. There is no obligation for the presence of independent directors on boards, which are in most cases dominated either by civil servants or by persons politically connected to the executive.

The financial market

Financial stability

The banking sector remains well-funded, liquid and profitable, but the share of non-performing loans remains elevated. The financial sector is dominated by banks which account for about 90% of the system's assets. Concentration remains high and unchanged compared to previous years, with some 58% of assets held by the three biggest banks. There are 15 banks in total, most of which are foreign-owned. Liquidity was abundant, partly reflecting banks' sluggish lending and their diminished appetite for government securities. The capital adequacy ratio rose further in 2017, and at end-year amounted to more than double the regulatory minimum of 8%. Banks' profitability continued to increase, yet more slowly than in preceding years. To support banks' solvency, the Basel III capital standards were adopted in October 2016 and came into force in March 2017. The quality of banks' assets improved slightly in the second half of the year: the share of non-performing loans (NPL) in total loans to the non-financial sector amounted to 6.3% end of 2017 (0.4pps lower than in mid-2017). However, not including the mandatory write-offs since 2016, the NPL share remains at about 10%. The central bank took further measures in 2017 to resolve the NPL problem, including the clarification of what constitutes a write-off. However, the high share of NPL on banks' balance sheets remains an obstacle to credit extension and to the transmission of monetary policy. Further measures are necessary to address this problem.

Access to finance

The level of financial intermediation increased further with assets, credit and deposits rising as a share of GDP. Bank lending to the non-financial private sector has picked up since spring 2017, and at end-year the amount of outstanding loans was some 5.6% higher than one year earlier. Corporate credit, which had been declining, in annual terms, since summer 2016, bottomed out in autumn 2017 and has picked up progressively since then. Commercial bank loans remain by far the main source of financing for small and medium-sized businesses, which are generally hesitant about funding their financial needs on the capital markets. While corporate bond and venture capital markets remain underdeveloped, opportunities for equity funding were strengthened in 2016 through the setup of stock market linkages with other exchanges in the region ("SEE link"). The legal framework for investment funds has been harmonised with EU regulations.

The labour market

The economy has created a large number of jobs in recent years. Driven by vast government employment programmes, the labour market has posted solid, though decreasing employment gains, amounting to some 2.8% on average each year between 2012 and 2016. In the last quarter of 2017, employment increased by 1.9% in annual terms. Foreign direct investors receiving government support for recruitment also expanded employment. As a result, amidst a declining labour force, the overall unemployment rate dropped further, by 1.2pps, in the last quarter of 2017, compared to the same period one year earlier.

But labour market distortions restrain growth potential. The decrease in unemployment partly reflects the low and declining activity rates. Moreover, the gender gap remains significant, with about 78% of men participating in the labour market, compared to 52% of women (2017, age 15-64). The overall employment rate has increased gradually, from 44% in 2012 to about 51% in 2017, but remains at a low level. Given the low female participation rates, women of working age are less likely to be in employment than men. Youth unemployment has been slowly, but steadily declining in recent years, but remains high, at 47%.. Most of the unemployment is long-term, still making up some 19% of the labour force, even though this share has been decreasing somewhat in the last five years. Large-scale emigration of skilled workers and low levels of enrolment in post-secondary education have left the economy struggling to rebuild a qualified young workforce. This holds back potential growth and delays the structural transformation of the economy, as it impedes the reallocation of resources towards sectors with higher productivity.

Figure 2.3. Unemployment in the former Yugoslav Republic of Macedonia
(% of Active population)

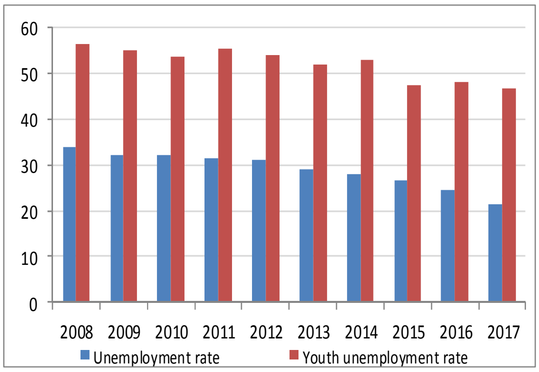


Figure 2.4. Participation rates in the former Yugoslav Republic of Macedonia
(% of Labour Force)

Source: Eurostat, national sources

Employment in the informal economy is declining, but remains high. According to the national Statistical Office, about 18% of total employment in 2016 took place in the informal economy. This share has decreased steadily from 28.6% in 2008, supported by government measures incentivising formal employment by subsidising labour costs in recent years. Informal work is distributed unevenly among population groups, with a particularly high share for young workers, women and the long-term unemployed. High and flat social security contributions likely pose a disincentive for workers to leave informal work.

2.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

The economy has made **some progress** and is at a **moderate level of preparation** to cope with competitive pressures and market forces within the EU. Further progress was made towards diversification of exports and higher-value added output in the manufacturing sector. Trade and investment relations with the EU continued to intensify. The economy still suffers from weaknesses in education curricula, low innovation rates and important investment gaps including in particular public infrastructure.

In order to support long-term growth, the former Yugoslav Republic of Macedonia should pay particular attention to:

→ improving the employability of graduates by reforming education curricula;

→ stimulating growth-enhancing investments, in particular in research and development and digitalisation;

→ strengthening links between foreign investors and the local economy.

Education and innovation

The educational system is slow in addressing the skills mismatch. While public expenditure on education, at about 4% of GDP, is only slightly lower than the EU average, enrolment and completion rates in secondary (about 87% completion) and post-secondary education have risen only marginally in the past five years, and remain below EU average. The gap between the skills of graduates and the needs of private companies narrows only slowly. The required move from traditional facts-based learning to the acquisition of general, transversal skills necessitates wider inclusion of the business sector in profiling and implementing programmes. The government has adopted many strategic documents addressing these challenges, but implementation remains partial. The Skills Observatory, intended to map and update graduates' competencies and labour market needs, developed jointly with the World Bank, has yet to be implemented. These shortcomings hamper the employability and productivity of graduates. The new government tackles some of these issues in its "Economic Growth Plan", adopted in December 2017.

Innovation rates in the private sector remain low. Expenditure on research and innovation remains modest, compared to the EU average, at 0.4% of GDP (2015), only slightly higher than in 2010. The bulk of this expenditure is accounted for by public spending, which has increased in recent years. Even though the share of technology-intensive products in exports has risen (due to production by established foreign companies), innovation and technological development in private companies remains at a low level. Grants provided by the Innovation Fund, which started disbursements in 2015 to stimulate R&D in SMEs, have had a slow take-up. Hence, a stronger orientation towards a knowledge-based growth model requires an important boost in the innovative capacity of the country. The government's "Economic Growth Plan" has identified and addressed obstacles to faster innovation, such as weak absorption capacities of companies, and the lack of cooperation between academic research and companies. The plan foresees increased public funding for R&D departments in manufacturing companies.

Physical capital and quality of infrastructure

Weaknesses in the economy's capital stock are hampering competitiveness. Private and public investment spending remains insufficient in view of the shortcomings in the country's infrastructure and production potential. Investment expenditure has remained largely constant at around 24% of GDP between 2012 and 2016. Some 70 % of investment was carried out by private enterprises (domestic and foreign), while the remainder is public investment financed via the general government budget, international financial institutions and public enterprises. In 2016 and early 2017, public investment was largely blocked in the run-up to elections. Private investors lost confidence in the business environment given the prolonged political crisis. The quality of the existing capital stock is generally low, even though foreign direct investment boosted the modernisation of production plants in some sectors. Modernisation needs accumulate in transport, energy, health and education infrastructure. These shortcomings contributed to the decline in labour productivity in recent years and hold back the economy's potential for growth. In the energy sector, too, there is an important investment gap. Low capacity for power production leads to frequent outages. Losses from power transmission and distribution diminish efficiency. The economy relies heavily on power from lignite and coal, and needs to develop renewable sources of energy.

Regional connectivity in transport and energy remains limited. Road and rail connections to neighbouring economies are advancing. The last part of the Corridor X motorway in the country is about to be completed in 2018, while the rail connection upgrading is sluggish, as is Corridor VIII related road works. The ongoing construction of a joint railway border crossing to Serbia is projected to be completed in 2021. The implementation of projects is often protracted due to issues such as cumbersome procurement procedures and poor performance of contractors. The establishment of a cross-border power exchange, as foreseen in the energy reform measures, is hampered by continued price regulation in the national electricity market. Distribution of cross-border transmission capacities is operational with Greece, and system operators in Serbia and Bulgaria are expected to follow.

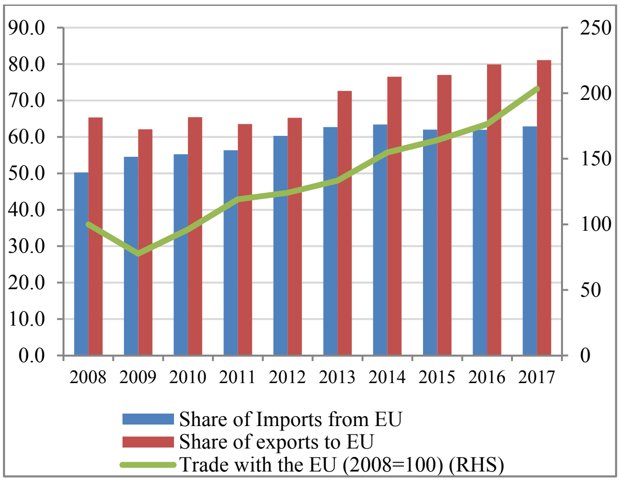
The digitalisation of the economy is progressing fast. The percentage of households with internet access at home has increased by 17pps between 2012 and 2016 (75.3%), and mobile broadband penetration is also expanding further. However, fixed broadband penetration is comparatively low and not improving, impacting negatively on business competitiveness.

Sectoral and enterprise structures

The structural transformation of the economy has been slow and has remained driven by foreign investment. The sectoral structure of the economy has remained largely unchanged in the past five years. At some 60% of estimated gross value added, services accounted for the largest share of gross value added also in 2017 (-5pps compared to 2012), with agriculture adding over 10%. Industry contributed 19.5% (+1.5pps compared to 2012). Mainly on account of foreign companies, the share of higher-value manufactured goods (machinery and equipment, chemical products) in industry output rose at the expense of basic manufactured goods such as iron, steel and clothing. Services provide half of the economy's jobs, followed by industry and construction (27%) and agriculture (24%), without significant changes since 2012. Over 99% of all companies are SMEs, providing over 76% of value added and an almost equal amount of employment.

Economic integration with the EU and price competitiveness

Figure 2.5. The former Yugoslav Republic of Macedonia: trade integration with the EU



Source: Eurostat, national sources

The importance of the EU as a trade and investment partner continues to grow. The value of merchandise trade with the EU has increased progressively in the past decade and amounted to 71% of the country's total trade in 2017. EU member states received 81% of the country's exports in 2017 (+1.2 pps y-o-y), and provided 63% of the country's imports (+0.9 pps y-o-y). Trade with other CEFTA countries also increased in 2017 (exports and imports increased by 9%). However, due to the stronger growth of trade with the EU, the CEFTA share in total trade declined slighty (by 0.5 pps, to 10.5%. However, compared to the same period in 2012, exports to this region more than doubled. The share of the stock of EU investments in total foreign investment increased in 2016 to 79%, while it had remained stagnant in the preceding five years. FDI stock per capita remains low. The development of a Regional Economic Area based on EU rules and standards, to which all Western Balkan economies have committed, has the potential to generate untapped growth.

Improved external competitiveness depends on diversification of the export structure. The economy posts a high and growing degree of trade openness. The total value of trade in goods and services amounted to 124% of GDP in 2017 (+10pps y-o-y). The composition of exports diversified further in 2017. The shares of iron and steel products, and clothing in total exports have fallen further, to the benefit of chemicals and machinery and transport equipment, which account for over 60% of total exports. This supported the structural transformation of the economy, which, however, in general is proceeding slowly. The international cost competitiveness of the economy deteriorated slightly in 2016 and 2017, as the increase in gross wages outpaced labour productivity growth. The real effective exchange rate (CPI-based) has remained stable in the past 5 years.

2.3. CONCLUSIONS

As regards the economic criteria, the former Yugoslav Republic of Macedonia has made some progress and is at a good level of preparation in developing a functioning market economy. Despite the political stalemate in the first half of the year, noteworthy improvements took place, in particular in public finance management and transparency. Key weaknesses of the economy remain. These include shortcomings in the business environment, such as weak contract enforcement and a large informal economy. Structural problems of the labour market are reflected in low activity and high unemployment rates. The macroeconomic environment deteriorated in the first half of 2017, as the lengthy political crisis took a toll on investment. Fiscal policy is geared towards short-term measures and lacks a durable consolidation plan.

The economy has made some progress and is moderately prepared to cope with competitive pressures and market forces within the EU. Further progress was made towards diversification of exports and higher-value added output in the manufacturing sector. Trade and investment relations with the EU continued to intensify. The economy still suffers from weaknesses in education curricula, low innovation rates and important investment gaps including in particular public infrastructure.

3. MONTENEGRO

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. Each enlargement country prepares an Economic Reform Programme (ERP) annually, which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

3.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Montenegro has made **some progress** and is **moderately prepared** in developing a functioning market economy. Macroeconomic and fiscal stability were strengthened but further efforts are required to address persistent challenges, especially the high public debt burden. The economy has been growing uninterruptedly since 2013 amidst low or moderate inflation. The financial sector has improved its solvency and liquidity. However, the export base needs to improve in scope and in quality to reduce the trade deficit. Rule of law weaknesses, including unfair competition from the informal economy, negatively impact on the business environment. The labour market faces structural challenges, reflected in low participation and high unemployment rates.

In order to support long-term growth, Montenegro should pay particular attention to:

→ continue fiscal consolidation efforts to strengthen the sustainability of public finances;

→ facilitate the resolution of non-performing loans (NPLs);

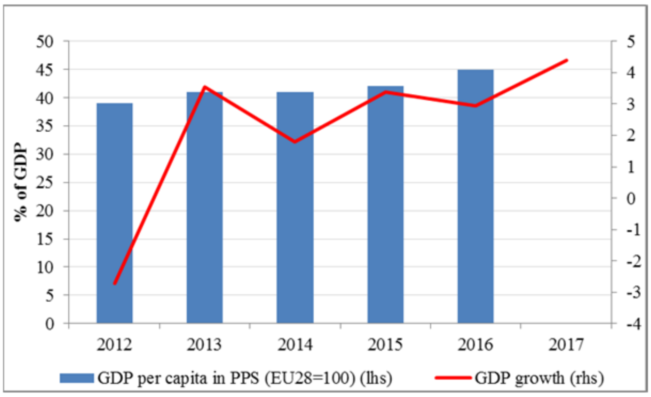
→ improve labour market flexibility to boost participation rates and reduce informality.

Economic governance

The long-term orientation of economic policy needs to be strengthened further. Unaffordable public spending increases in the run-up to the last parliamentary elections in October 2016 required severe corrective measures. The new government's frontloaded fiscal consolidation policy and reforms helped redressing some of the negative impact on public finances and labour market participation, in particular of women. Efforts should be maintained to avoid a reversal of consolidation policies and a deterioration of macroeconomic stability. The policy guidance jointly adopted in May 2017 has been partially implemented.

Macroeconomic stability

Figure 3.1. Montenegro convergence



Source: Eurostat, national sources

The pace of economic growth continues to strengthen. From 2012, when the last recession episode took place, to 2016, the economy recorded annual average growth of 2.9 %. GDP accelerated further in the first three quarters of 2017, registering an average expansion of 4.4 % y-o-y, driven by private consumption and investment. Household consumption increased partly due to a record-breaking tourist season boosting domestic demand and employment. Investment expanded by 10.5 % y-o-y until September 2017, driven by public capital spending on the highway project and on private investment in tourism and energy. After several years containing maintenance costs, government consumption started to grow in 2017. Exports have been supported by a boom in tourism. However, growing domestic demand meant that growth in imports also matched the pace of export growth, leading to a negative contribution from net exports. Five years of continuous growth resulted in some further economic convergence with the EU. In 2016, Montenegro's GDP per capita expressed in purchasing power standards rose to 45 % of the EU average, up from 39 % in 2012.

The trade deficit continues to worsen, despite strong exports performance. In 2017, the merchandise trade deficit further increased to 44.2 % of GDP, up from 41.9 % a year earlier. As a result, the current account deficit deepened to 19.0 % of GDP, up from 18.1 % a year earlier, in spite of the improvement of the services account benefitting from the strong tourism season. Improvements in merchandise exports have been largely related to crude (and low value added) material, while project-related purchases of construction material and equipment, but also higher oil prices, maintained upward pressure on imports, surging by 22 % y-o-y in the last quarter of 2017. In 2017, net FDI inflows totalled 11.3 % of GDP, compared to 9.4 % in 2016, covering 59.3 % of the current account deficit; the rest of the external gap being financed by loans (31.7 %) and portfolio investments (3.2 %).

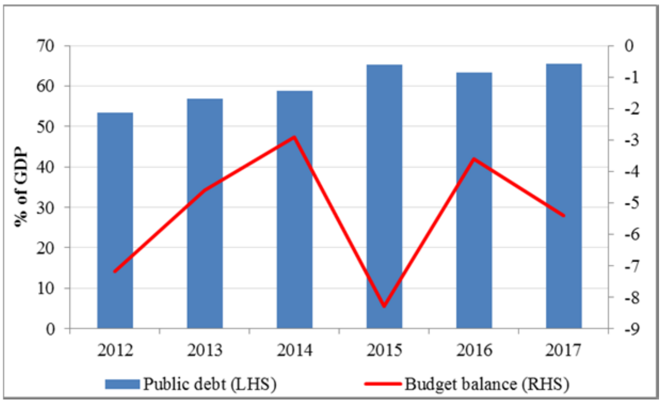
Table 3.1: **Montenegro - Main economic trends**

		2012	2013	2014	2015	2016	2017
Gross domestic product	Ann. % ch	-2.7	3.5	1.8	3.4	2.9	4.4
Private consumption	Ann. % ch	-3.9	1.6	2.9	2.2	5.4	4.2
Gross fixed capital formation	Ann. % ch	-2.4	10.7	-2.5	11.9	27.5	15.8
Unemployment rate	%	19.7	19.5	18.2	17.8	18.0	16.4
Employment	Ann. % ch	2.2	1.4	6.6	1.9	1.1	2.1
Wages	Ann. % ch	0.8	-0.2	-0.3	0.2	3.5	2.0
Current account balance**	% of GDP	-18.5	-14.5	-15.2	-13.2	-18.1	-18.9
Direct investment (FDI, net)**	% of GDP	14.5	9.6	10.2	16.9	9.4	11.2
HICP, average	Ann. % ch	4.0	1.8	-0.5	1.4	0.1	2.8
Exchange rate EUR/EUR	Value	1.0	1.0	1.0	1.0	1.0	1.0
General government balance	% of GDP	-7.2	-4.6	-2.9	-8.3	-3.6	-5.4
Central government debt	% of GDP	53.4	56.9	58.7	65.2	63.4	65.1

** refers to a 4 quarters moving average.
Source: Macrobond, Eurostat

Inflation increased, driven by rising international commodity prices. Inflation remained historically low in the period 2013-2016, with average annual rates of below 2 %. However, since the end of 2016, import prices grew faster as the cost of petroleum products kept rising over the year. Meanwhile, domestic price pressures have remained modest as average nominal wage growth has lingered markedly below inflation in the last five years with the exception of 2016. Overall, the harmonised index of consumer prices grew by 2.8 % y-o-y in 2017, compared to 0.7 % a year before. Higher value added taxes and an increase in regulated electricity prices are set to generate additional inflationary pressures in 2018.

Figure 3.2. Montenegro fiscal developments



Source: Eurostat, national sources

The new government introduced a more stringent fiscal policy to address debt-related concerns. Along with the 2017 budget, a plan was adopted for redressing public finances at the end of 2016. This plan was complemented in July 2017 with a relatively more ambitious medium-term fiscal strategy, including further increase of excises and VAT, adjusting social benefits, introducing additional cuts in public sector wages, and introducing a new excise on coal. These corrective measures, whose combined fiscal impact is estimated at 3.6 % of GDP over 4 years, are expected to bring the budget close to balance in 2019 and to lower the public debt ratio as of 2020. Budget performance in 2017 reflects a threefold surge in capital spending over the year, totalling 6.1 % of GDP, along with improved performance of tax revenue collection, rising by 20 % y-o-y, driven by VAT, excises and social security contributions. Overall, in 2017, the central government accumulated a deficit of 5.6 % of GDP compared with 3.4 % in 2016.

Public debt growth is driven to a large extent by financing the main section of the Bar-Boljare highway. In 2016, a slowdown of the highway works plus an upwards revision of GDP resulted in only a slight increase of the public debt to 64.4 % of GDP. After resuming the works on the highway in 2017 (worth some 4.6 % of GDP), preliminary estimates from the Ministry of Finance indicate public debt totalled 66 % of GDP at the end of the year. State guarantees accounts for some additional 10.9 % of GDP. Overall, given the high levels of public debt, its repayment profile and the tightening of global financial conditions, it is essential to rebalance the budget structure towards growth-enhancing spending and to continue fiscal consolidation efforts.

Given the constraints stemming from Montenegro's unilateral use of the euro, a restrictive fiscal stance appears to be justified to rebuild buffers and reduce debt-related vulnerabilities during the current cyclical upswing. The plan for improving public finances adopted at the end of 2016 and the medium-term fiscal strategy of July 2017 represent two important steps to address a very high and increasing debt level. The continuation of fiscal consolidation remains essential for the sustainability of public finances and for achieving gradual compliance with Montenegro's fiscal rules, by adopting additional measures if needed.

Functioning of product markets

Business environment

There was no significant improvement in the business environment. In accordance with the public administration reform strategy 2016-2020, the number of electronic services offered via the e-Government portal increased. It is also planned to optimise the capacity of the public services. However, the poor implementation of laws and delays in obtaining information and services need to be addressed. The introduction of electronic cadastral services to improve data updating is still pending. A new law on spatial planning and construction was adopted in October 2017, albeit implementing legislation is yet to be adopted. Moreover, challenges remain in the construction industry, notably high permit costs, and lengthy procedures for paying taxes and property registration. Despite these barriers, the number of companies and entrepreneurs increased by 3.6 % y-o-y in 2017. Market exit procedures seem broadly efficient, with 90 % of bankruptcy procedures taking up to six months, and only 1 % of cases requiring longer than one year. Indebtedness and liquidity constraints affect the corporate sector. At the end of December 2017, there were 16,220 companies and entrepreneurs (including inactive ones) with frozen bank accounts due to unpaid claims.

Despite some progress with legal proceedings, a consistent and efficient application of legislation is still necessary to ensure legal certainty and predictability. The bailiff system continues making progress with the introduction of a centralised case management system. In the period from October 2015 to December 2016, 50.9 % of the total enforcement cases were solved, of which 89.6 % through the complete collection of claims. Alternative dispute resolution remains low, with only 161 cases referred for mediation in 2017 compared to 429 in 2016. Weaknesses in the area of rule of law negatively impact on the business environment. Investors complain about the inconsistency of case law, non-enforcement of court orders and interferences with property rights of investors. Unfair competition from the informal economy is also considered a severe obstacle.

State influence on product markets

State aid allocation from the budget is declining but the regime of tax exemptions and other types of support require an in-depth review of their economic impact. In the first eleven months of 2017, budget allocation for subsidies declined to 0.47 % of GDP. The government did not extend any new state guarantees in 2016, and just two new guarantees in the first nine months of 2017, totalling 0.6 % of GDP. However, there are concerns about continuing support to the national airline *(See more under Chapter 8)* and the need for a comprehensive restructuring of the company.

Privatisation and restructuring

The privatisation process advanced further notwithstanding some setbacks. State ownership in the economy is limited a few companies. However, information on the size, composition and performance for the entire SOE sector is difficult to obtain. In 2017, the bankrupt textile producer Vunko was sold, and a lease granted to an international hotel operator to upgrade and manage two state-owned hotels. Negotiations for selling the shipyard in Bijela are well advanced. However, some privatisations stalled or reversed. In April 2017, the government halted the negotiations on the sale of the Port of Bar and the rail company Montecargo, arguing low price and unclear plans from the bidder. Unless a new investor is found, state participation in the economy is set to increase (entailing some contingent fiscal risks) as a result of the withdrawal of a major investor's 41.7 % stake in the electric power company EPCG.

Functioning of the financial market

Financial stability

The banking system as a whole improved its solvency and liquidity position. There are fifteen banks in Montenegro, with foreign-owned banks accounting for 80.4 % of total capital, largely dominating the sector. Considering the relatively large number of entities and the small size of the economy, some mergers and acquisitions could be expected in the medium term. In 2017, the aggregated capital adequacy ratio was 16.4 %, well above the regulatory minimum of 10 %. Banks' profitability remains low albeit improving, with return on assets (ROA) and return on equity (ROE) of 0.9 % and 6.9 % respectively. The ratio of NPLs dropped to 7.3 % of total loans at the end of 2017 as a result of sell-offs of impaired assets to factoring companies and, more recently, new regulation facilitating loan restructuring and the clearing of banks' balance sheets. However, large disparities still remain across lenders, with the smaller non-EU and domestic banks presenting a significantly weaker position, calling for the reinforcement of the banking supervision framework and carrying out independent asset quality reviews for all banks.

Access to finance

Corporate sector borrowing remains below pre-crisis levels. Lending increased by 11.8 % y-o-y in 2017, but credit to privately-owned companies remained subdued, recording average 3.2 % annual growth in 2017. This contrasts with the household sector, which recorded a much stronger (11.1 % y-o-y) growth in the same period. The low credit growth to corporates is the result of risk aversion among banks driven –among others– by the poor investment readiness of firms, the lack of standardized financial reporting, low effectiveness of the judicial system, and credit registry data gaps. The reduction of non-performing loans was accompanied by a further lowering of financing costs for domestic companies. In December 2017, the weighted average effective interest rate amounted to 5.70 %, down from 6.38 % a year earlier.

The non-bank financial sector is underdeveloped. The stock market turnover is very low, at just 1.0 % of GDP and most of the operations relate to the secondary market. The insurance market is also modest, with gross premiums totalling some 1.6 % of GDP in 2017. The size of the leasing market remained marginal, accounting for 0.4 % of GDP in the first three quarter of 2017. Total assets and liabilities of micro-financial institutions amounted to 1.4 % of GDP at the end of October 2017. The lending capacity of the state-run Investment Development Fund (IDF) reached 4.2 % of GDP in 2017, comparable to a medium-sized bank.

Functioning of the labour market

Economic growth and the rollback of some unaffordable social benefits are slowly improving labour market trends. In the third quarter of 2017, the unemployment rate according to the labour force survey declined to 15.1 % from 17.1 % a year before, while the employment rate increased to 55.6 % from 51.4 % a year earlier. By gender, the employment rate of men reached 62.1 % compared to 49.1 % for women. Youth unemployment is high at 27.5 %, although declining from 33.5 % a year before. The long-term unemployment rate was broadly unchanged at 73.4 %. Data from the Employment Agency presents a more negative picture: at the end of 2017, employment dropped by 7.6 % y-o-y while the unemployment rate reached 22.2 %, up from 21.1 % a year before. Discrepancies could be explained to some extent by the high proportion of informal employment, but also, by the revision of the social programme for mothers of three children or more, after which several thousand mothers returned from a pensioner status back to the labour market as unemployed.

Fear of losing social protection benefits hinders the transition to formal work. The high marginal effective tax rate on earnings below social assistance levels combined with ineffective labour inspections presents a disincentive for people to transit from informal to formal sector jobs, including part-time and seasonal jobs, which are filled to a large extent by workers from neighbouring countries. Since May 2017, real wages have declined due to the acceleration of inflation and the waning of the growth effects from the previous year's hike of public sector salaries. In consequence, the average gross wage contracted by 0.8 % y-o-y in real terms in 2017.

Figure 3.3. Unemployment in Montenegro (% of Active population)

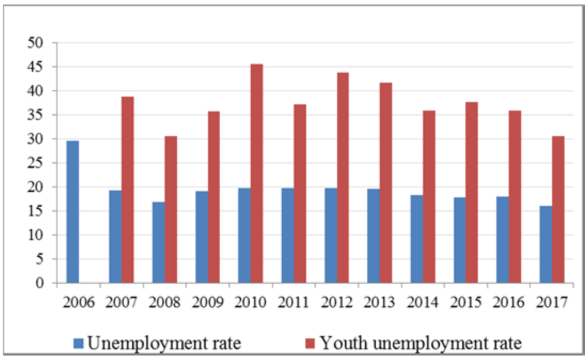
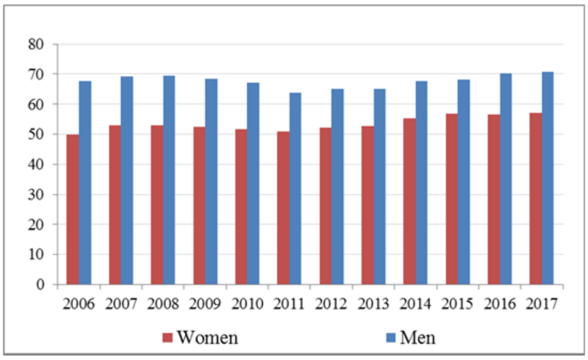


Figure 3.4. Participation rate in Montenegro (% of Labour Force)



Source: Eurostat, national sources

3.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Montenegro has made **some progress** and is **moderately prepared** in terms of capacity to cope with competitive pressure and market forces within the Union. The construction of key infrastructure in a number of areas as well as developing human capital set the basis for improved competitiveness. Education reform is ongoing, but more efforts are needed to address the skills mismatch. SMEs remain confronted with numerous challenges, such as access to finance or regulatory complexity. Further efforts are still required to improve the overall export performance of local companies.

In order to support long-term growth, Montenegro should pay particular attention to:

→ continue the development of research and innovation capacities to facilitate synergies between academic institutions and enterprises;

→ develop infrastructure in a fiscally responsible manner, respecting competition and public procurement rules;

→ continue to address the mismatch between education outcomes and labour market needs.

Education and innovation

Investment in research and development remains modest. Montenegro has been participating in numerous international programmes and cooperation projects *(See Chapter 25: Science and Research)*. National programmes are largely funded by the government, while private sector funding remains marginal. Several institutional frameworks for science and development linking the business and academic community are being implemented, namely the BIO-ICT Centre of Excellence and the Innovative Entrepreneurship Centre “Tehnopolis”. Activities are also underway to establish a Science and Technological Park within the campus of the University of Montenegro in Podgorica.

Montenegro's education system is undergoing a broad reform to improve its quality. A legislative package was adopted in 2017 to facilitate that practical knowledge and skills are better developed at all levels. It also established, among other measures *(see Chapter 26: Education and Culture)*, an Agency for the Control and Quality Assurance in Higher Education and introduced financial incentives to promote excellence of teachers and students.

Efforts continued to modernise secondary vocational education. To facilitate school to work transition, amendments to the law on vocational education were adopted in July 2017, introducing the so-called 'dual education system', which requires practical training with employers. A subsequent information campaign has contributed to a 15 % higher enrolment under the new system for the 2017/2018 school year, whereby 264 students signed contracts with 97 employers. However, the quality of vocational education and training needs to be improved.

Physical capital and quality of infrastructure

Insufficient and inadequate infrastructure remains a challenge. The quality of the road network is below European standards. Reconstruction and modernisation of the road network is advancing according to plan, including the construction of the priority section of the highway. The railway system is inexpensive; however, services are quite limited, slow and outdated. Several track sections as well as signalling are being upgraded. The airports also require higher capacity to cater for the fast growing number of passengers. Modernisation of the port of Bar is underway, in particular in the container terminal. However, the intermodal connection with the railways requires a major overhaul. The electricity mix is overly reliant on hydropower and thermal sources, but insufficient to cover the needs of the country. Diversification advanced with the construction of the first wind energy plant, which became operational in November 2017. The electricity transmission corridor towards Italy is under construction. A number of waste management plants and water distribution and treatment systems are currently under construction.

The Strategy for the development of the information society is ambitious. The goal is to enable basic broadband access to all the population already in 2018, and with high speed broadband access (30 Mbit/s or more) in 2020. The electronic communication infrastructure is used by 11 operators. However, low investment in fixed-line broadband infrastructure has this far resulted in the slowest broadband connections in the region.

Sectoral and enterprise structures

Little change was recorded in the structure of the economy. Services remain the predominant engine of the economy, with 71.8 % of total gross value added in 2016, compared to 11.9 % for the industrial sector, 10.9 % for agriculture, and 5.4 % for construction. The predominance of services is even more pronounced when observing employment by sectors, accounting for 84.8 % of the jobs, with total employment in industry and agriculture far behind with 7.8 % and 7.4 % respectively.

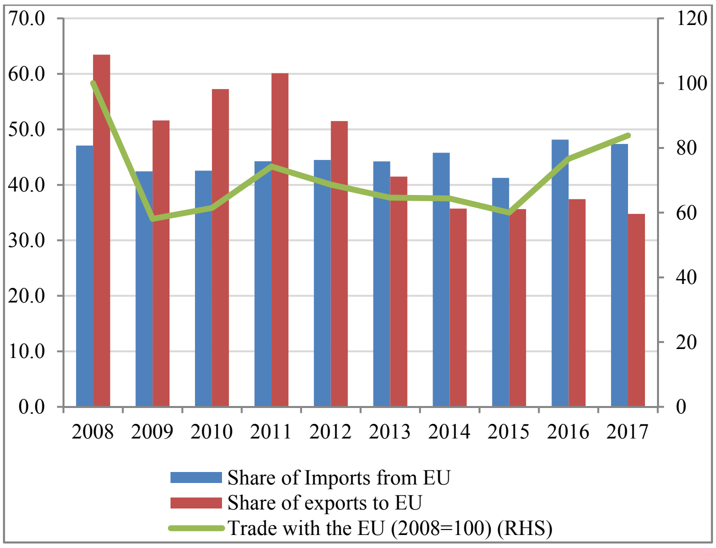
SMEs are the backbone of Montenegro's economy. Nearly 70 % of value added and more than three quarters of national employment is generated by SMEs, compared with an average of 57 % and two thirds respectively in the EU. However, SMEs are confronted with numerous challenges, like the complexity of business-related legislation, particularly at local level, or the lack of access to affordable finance. In addition, these firms remain focused on the domestic market and need to become more regionally competitive to strengthen their impact on the national economy. The Investment and Development Fund channels the largest portion of public sector financial support to SMEs through credit lines, financing and factoring services.

Economic integration with the EU and price competitiveness

The share of trade with the EU and CEFTA countries is high but declining, as exchanges with other countries, like China and Turkey, increase. In 2017, trade with the EU accounted for 34.7 % of

Montenegro's goods exports and 47.4 % of its merchandise imports. Trade with CEFTA represented 41.1 % of exports and 31.2 % of imports. The development of a Regional Economic Area based on EU rules and standards, to which all Western Balkan economies have committed, has the potential to generate untapped growth. Financial integration with the EU is also substantial, accounting for 88.4 % of foreign share of capital in local banks and 38.7 % of total FDI inflows in 2017.

Figure 3.5. Montenegro trade integration with the EU



Source: Eurostat, national sources

Montenegro needs to improve its export performance. In 2016, the total value of traded goods and services totalled 103.4 % of GDP, with exports representing only 40.5 % of GDP. The country has a small manufacturing base concentrated on commodities with low value-added. However, exports of services are growing fast thanks to important investment on high-end tourism facilities. Imports are largely concentrated on energy and food, two sectors which offer significant potential for import substitution.

Price competitiveness has been broadly preserved due to moderate import prices and low labour costs. Labour costs have declined in real terms each year since 2011, except for a 3.4 % y-o-y increase in 2016. Consequently, domestic producer prices remained flat or recorded some marginal annual increase of less than 0.3 % in each of the last three years, preserving local companies' competitiveness.

3.3. CONCLUSIONS

As regards the economic criteria, Montenegro has made some progress and is moderately prepared in developing a functioning market economy. Macroeconomic and fiscal stability were strengthened but further efforts are required to address persistent challenges, especially the high public debt burden. The economy has been growing uninterruptedly since 2013 amidst low or moderate inflation. The financial sector has improved its solvency and liquidity. However, the export base needs to improve in scope and in quality to reduce the trade deficit. Rule of law weaknesses, including unfair competition from the informal economy, negatively impact on the business environment. The labour market faces structural challenges, reflected in low participation and high unemployment rates.

Montenegro has made some progress and is moderately prepared in terms of capacity to cope with competitive pressure and market forces within the Union. The construction of key infrastructure in a number of areas as well as developing human capital set the basis for improved competitiveness. Education reform is ongoing, but more efforts are needed to address the skills mismatch. SMEs remain confronted with numerous challenges, such as access to finance or regulatory complexity. Further efforts are still required to improve the overall export performance of local companies.

4. SERBIA

In line with the conclusions of the June 1993 European Council in Copenhagen, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the EU.

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. Each enlargement country prepares an Economic Reform Programme (ERP) annually, which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU, the Western Balkans and Turkey at ministerial level in May each year.

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Serbia has made **good progress** and is **moderately prepared** in developing a functioning market economy. Some of the policy weaknesses, in particular with regard to the budget deficit, were addressed. Growth fundamentals are sound and macroeconomic stability was preserved. Price pressures were subdued and monetary policy supported growth. The restructuring and privatisation of state-owned enterprises partially advanced. The stability and performance of the financial sector strengthened. Labour market conditions improved further.

However, government debt is still high and budgetary framework and governance need to be strengthened. External imbalances increased. Major structural reforms of public administration, the tax authority, and state-owned enterprises (SOEs) remain incomplete. Unemployment and economic inactivity are high, particularly among women and youth. The private sector is underdeveloped and hampered by weaknesses in the rule of law and the enforcement of fair competition.

In order to support long-term growth, Serbia should pay particular attention to:

→ sustain good fiscal results in order to lower government debt and improving revenue collection in a systematic and business-friendly way;

→ continue the restructuring and privatisation of state-owned enterprises and public administration reform;

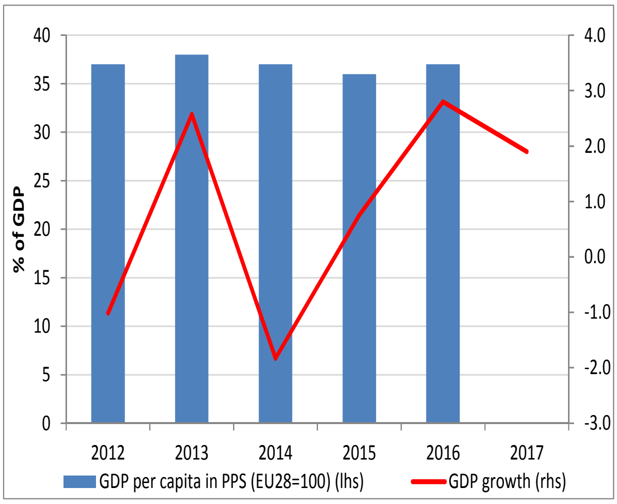
→ enhance labour market participation and employment especially for women and youth.

Economic governance

Despite delays in key structural reforms, the authorities remain committed to creating a functioning market economy. The implementation of the Stand-By Arrangement with the International Monetary Fund was completed successfully in February 2018. The policy guidance jointly adopted in May 2017 has been partially implemented. The strong budget performance continued unabated and, along with low inflation and well-anchored inflationary expectations, it allowed additional monetary policy relaxation. Reforms of the public administration, the tax administration, and the restructuring of large state-owned enterprises advanced slowly. Financial stability strengthened. Following recent strides in improving the business environment, efforts in this area weakened.

Macroeconomic stability

Figure 4.1. Serbia GDP growth



Source: Eurostat, national sources

Growth fundamentals and prospects are sound. Although economic growth decelerated to 1.9 % in 2017 due to temporary shocks in energy and agricultural production, the underlying growth trend remains vibrant. Economic activity continues to be supported by a strong export expansion and rising investment. This growth model is further sustained by foreign direct investment in tradable sectors. Private consumption, underpinned by higher income and employment levels, went up in 2017 and is poised to increasingly contribute to and drive the growth momentum of the economy. The income gap with the EU remained broadly unchanged: in 2016, per capita GDP in purchasing power terms stood at 37 % of the EU average, the same level as in 2012.

External imbalances increased but their financing was healthy and buffers remained adequate. After several years of decline, the current account deficit went up again to 5.7 % of GDP in 2017, driven by lower exports of agricultural goods as a result of a drought, worsening terms of trade, higher direct investment income outflows, and surging imports due to buoyant domestic demand. The deficit was, however, fully covered by net foreign direct investment which continued to be broad-based and increased for a third year in a row to reach 6.6 % of GDP. The level of external debt was broadly stable over previous years before declining to around 70 % of GDP in 2017. External risks were cushioned by sizeable official foreign exchange reserves which have consistently covered around six months' worth of imports of goods and services.

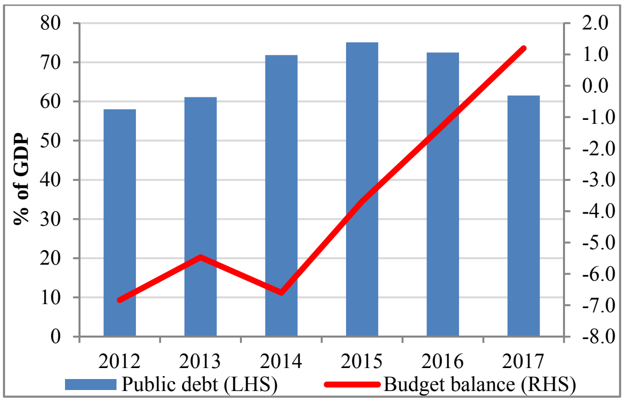
Table 4.1: **Serbia - Main economic trends**

		2012	2013	2014	2015	2016	2017
Gross domestic product	Ann. % ch	-1.0	2.6	-1.8	0.8	2.8	1.9
Private consumption	Ann. % ch	-2.1	-0.4	-1.3	0.4	0.8	1.8
Gross fixed capital formation	Ann. % ch	13.2	-12.0	-3.6	5.6	5.1	6.2
Unemployment (>15 years old)	rate %	23.9	22.1	19.2	17.7	15.3	13.5
Employment (registered)	Ann. % ch	-1.1	3.7	10.1	0.6	5.6	2.8
Wages (average, net real)	Ann. % ch	9.0	5.7	1.2	-0.4	3.8	3.9
Current account balance**	% of GDP	-11.6	-6.1	-6.0	-4.7	-3.1	-5.7
Direct investment (FDI, net)**	% of GDP	2.2	3.8	3.7	5.4	5.5	6.6
CPI (end of period)	Ann. % ch	12.2	7.9	2.1	1.4	1.1	3.0
Exchange rate RSD/EUR	Value	113.01	113.10	117.23	120.74	123.09	121.41
General government balance	% of GDP	-6.8	-5.5	-6.6	-3.7	-1.3	1.2
General government debt	% of GDP	55.9	59.6	70.4	74.7	71.9	61.5

** refers to a 4 quarters moving average.
Source: Macrobond, Eurostat

Inflation stayed close to the target and monetary policy further supported growth. 2017 ended with inflation at 3.0 %, exactly in the centre of the band targeted by the central bank. Price pressures remained subdued and inflation expectations contained. The continuing strong fiscal consolidation and dinar appreciation due to significant capital inflows were instrumental in achieving price stability. They also allowed monetary policy to become more accommodative: cuts in the key policy rate resumed in the autumn when it was lowered in two steps of 25 basis points each, to 3.5 %, followed by another 25 points cut in March. Lending conditions improved further and credit activity increased, boosted by past monetary policy easing and reduced risk premiums. The central bank intervened on the foreign exchange market buying a net EUR 0.7 billion in 2017.

Figure 4.2. Serbia fiscal developments



Source: Eurostat, national sources

Strong fiscal consolidation was decisive in instilling confidence in the economy and supporting the recovery. Between 2014 and 2017, the general government budget turned from a deficit of 6.6 % of GDP to a surplus of 1.2 %. Final budget outcomes outperformed significantly initially planned targets mainly because of an unexpectedly strong revenue performance, including some one-offs, like revenues from 4G licences, superdividends from state-owned companies etc. The structural improvement in the budget balance over this period was around 6 % of GDP, driven both by improved revenue collection and subdued current expenditure. The successful implementation of the consolidation programme created space for additional wage and pension increases which continued with the 2018 budget as well. For the first time, this year's budget also included a limited reduction of labour taxation, mainly in the low-income segment. As a result of prudent fiscal policy, the growth of government debt was reversed: after peaking at 74.6 % of GDP in 2015, it fell to 61.5 % of GDP in 2017. Although interest payments have declined, they are still significant and debt service costs remain sensitive to interest and exchange rate fluctuations.

Good fiscal results need to be sustained in view of the still high indebtedness and elevated risks. The share of mandatory expenditure is large and restrains the scope to increase productive spending. The unfinished reform of state-owned enterprises, in particular in the petrochemical, mining and energy sectors, remains a constant source of contingent liabilities and could easily undermine the hard-won fiscal sustainability. Improved tax revenue collection has been a major element of the recent consolidation. Preserving revenue gains, thus, calls for avoiding further delays in implementing the tax administration transformation programme which was updated in December 2017. Some elements of the cost-cutting programme of the previous years, like the partial employment freeze and the targeted reduction of pensions have been retained in 2018 but they are not a substitute for a systemic approach to expenditure restraint and constitute an implicit liability.

There are still important weaknesses in the budgetary framework and governance systems and efforts to strengthen them progressed slowly. Public administration reform advanced with delays. In particular, the implementation of the wage system reform in the public sector was postponed, and its introduction is now planned with the 2019 budget. There are still important shortcomings in the capital budgeting system. Capital expenditure execution underperformed last year despite efforts to improve the project appraisal process and establish a single project pipeline. As part of the public finance management programme, a new public internal financial control strategy was adopted in May 2017, together with a

2017-2018 action plan. The system of fiscal rules is weak as it is not sufficiently binding and relevant for policy-making, but work on its strengthening has been slow.

The macroeconomic policy mix was appropriate. It brought macroeconomic stability and improvement in major economic indicators. Although there are still significant economic challenges and headline economic growth was slow, the restrictive fiscal stance and accommodative monetary policy ensured price stability, stimulated investment activity, increased employment, and reduced the country risk premium. Full implementation of the public sector reforms and strengthening of key fiscal institutions would help sustain these results and support convergence with the EU.

Functioning of product markets

Business environment

The business environment improved somewhat, but significant weaknesses still need to be addressed. Over the last few years Serbia improved its standing in various international business rankings. This was mainly due to reforms facilitating the process of dealing with construction permits and registering property. The institutional and regulatory environment, however, remain weak. Business-relevant laws continue to be adopted under urgent procedures, without the necessary consultation of interested groups. Delays in the adoption of secondary legislation hamper the implementation of adopted laws. The courts enforcing property rights remain overburdened with a significant, although declining, backlog of cases. Property restitution continued, with more than half of the cases resolved, and restitution in kind is almost complete. Fair competition is negatively affected by the size of the informal economy, which remains considerable, estimated at up to 30 % of GDP. Unpredictable and unjustified para-fiscal charges continue to hamper the business environment. Licensing procedures under different authorities often lack transparency, creating a discriminatory business environment. More efforts are needed to streamline the work of different inspectorates.

State influence on product markets

The state presence in the economy slightly declined. The share of administered prices (estimated at 19 % of the consumer basket) was broadly unchanged. Advances in the privatisation and restructuring of state-owned enterprises (together with cyclical factors stemming from favourable international market developments) helped improve their financial performance. As a result, the level of direct state aid to them has fallen. Nevertheless, some enterprises accumulated new arrears and the non-transparent practice of taking over part of their debt by the state, in particular towards the electricity company EPS and the gas supplier Srbijagas, continued. Electricity prices increased slightly as of October 2017. Administrative capacity and political willingness to manage subsidies remains weak. The provision of budget subsidies to foreign investors, in a non-transparent manner and without systematic control of the state aid authority, also continued.

Privatisation and restructuring

Privatisation and restructuring of state-owned enterprises advanced, although challenges remain. After the Privatisation Agency closed in 2016, most of the companies in its portfolio went into bankruptcy proceedings. There were several successful privatisations of companies that had been a burden on public finances for years. Nevertheless, around 140 companies, employing some 50,000 people, remain to be resolved. A big part of the employment is concentrated in several large enterprises in the petrochemical and mining sectors. The authorities have committed to either launching privatisation tenders for them or seeking strategic investors in the first half of 2018. The restructuring of key utilities advanced with varied speed and success. "Railways of Serbia" has taken important steps towards reorganising its assets, network and staff. The state-owned power utility Elektroprivreda Srbije followed its restructuring plans only partially. The company also has to address corporate governance and management issues. These issues were a factor in the temporary decline in electricity production in early 2017. The payment collection rate of Srbijagas continued to improve and future investment decisions by the enterprise should be based on a new appraisal methodology. The delayed unbundling of the company and further strengthening of its operational and financial performance remains a priority.

Functioning of the financial market

Financial stability

The performance of the financial sector improved. The liquidity position of the banking system remained strong, while capital adequacy increased further from an already high level. The benign economic environment and lower provisioning needs boosted profitability to levels not seen before the 2008 crisis. The implementation of the resolution strategy for non-performing loans supported a reduction of the gross non-performing loans ratio to 11.1 % in November 2017 — its lowest value since 2009 and down by nearly half since its peak in 2015. In 2017, banks wrote off non-performing loans worth 2.3 % of GDP — most of it due to a central bank decision requiring the accounting write-off of fully provisioned non-performing loans. Despite these strong results, the level of non-performing loans is still high, and their reduction was uneven and less pronounced in state-owned banks. With the exception of preparations for steering Banka Postanska Stedionica towards retail banking, restructuring and privatisation plans for state-owned financial institutions have been delayed amid persistent governance issues. In the last 2 years, the proportion of overall deposits and loans in dinars rose, although still only slightly, driven mainly by higher dinarisation of household loans and deposits. Financial stability was enhanced by continuous improvements in the regulatory and macroprudential framework and in particular the introduction of Basel III standards last year.

Access to finance

Lending activity accelerated and access to finance improved. The financial system is dominated by foreign-owned commercial banks, which hold three quarters of banking system assets. The banking sector consolidated following the merger or sale of several small banks. State control of key entities in both the banking and insurance sectors has remained unchanged, as privatisation plans have been delayed. Lending conditions improved. The cost of corporate and household borrowing declined rapidly from the beginning of the monetary easing cycle in September 2013 until mid-2016, and has continued falling since then, although at a much lower pace. At the same time, in the last two years, demand for new loans started recovering and commercial banks eased their credit standards, contributing to increased credit activity. This was particularly marked in some segments of the market such as cash loans to households, which grew to rival housing loans and will need to be managed carefully to limit excesses and reduce financial system vulnerabilities. Total commercial bank lending to the non-monetary sector, excluding effects from the exchange rate and non-performing loan write-offs, increased by close to 10 % in 2017. However, it remained rather low, at an estimated 46 % of GDP.

Functioning of the labour market

Labour market conditions improved further, although unemployment is still high. In 2017 the employment rate reached 46.7 % — its highest level since the start of the (revised) labour force survey in 2014. The structure of employment improved slightly, as informal and agricultural employment declined, although both remained significant at around one fifth of total employment. Employment in industry and services and registered private sector employment increased. Wages grew only moderately. Unemployment fell significantly as gains in employment outweighed the number of those entering the labour market. However, at 13.5 % in 2017, it is still high. Long-term unemployment, i.e. the number of unemployed people looking for a job for more than a year, declined by around 35 % over the last three years. The position of women and youth on the labour market improved as well, although their rates of activity, employment and unemployment remained far worse than those of men.

Figure 4.3. Unemployment in Serbia (% of active population)

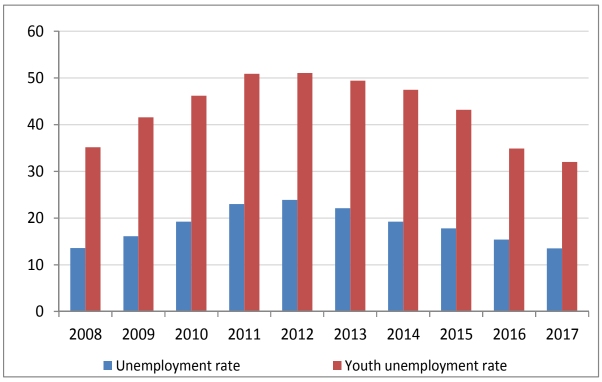
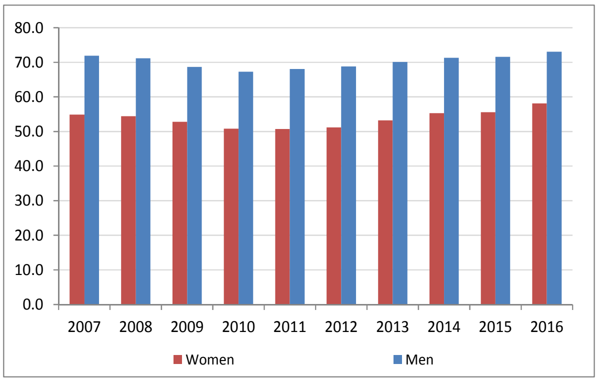


Figure 4.4. Participation rates in Serbia (% of labour force)



Source: Eurostat, national sources

Limited steps were taken to address major structural problems of the labour market. Demographic trends are very negative: the population is rapidly declining and aging. While demand for labour is growing, job creation is still inadequate. Emigration of the highly educated remains a serious challenge. Almost a quarter of all unemployed completed tertiary education, which points to a considerable gap between acquired skills and labour market demand. About 1 in 5 in the age group 15-24 is not in employment, education, or training, albeit there have been some improvements. Active labour market measures target young people, women, redundant workers released in the process of restructuring state-owned enterprises, and long-term unemployed. However, these measures are too limited, given the number of unemployed, and predominantly one-off like job counselling and job fairs. In an attempt to boost job creation, reduce undeclared work, and limit the impact on cost competitiveness of the decision to increase the minimum wage by 10 %, the government increased the non-taxable personal income threshold from the beginning of 2018. However, labour taxation, in particular the social security burden, remained disproportionally high for lower wages.

4.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE EU

Serbia has made **some progress** and is **moderately prepared** to cope with competitive pressure and market forces within the EU. The structure of the economy improved and economic integration with the EU increased further.

However, the quality, equity and relevance of education and training do not fully match societal and economic needs. The level of investment activity is also below the economy's needs. Despite some improvements, SMEs face a number of challenges, including high and unpredictable para-fiscal charges, and difficult and costly access to finance.

In order to support long-term growth, Serbia should pay particular attention to:

→ continue to improve the quality, equity and relevance of the education system;

→ stimulate private investment and improving prioritisation and management of public infrastructure projects;

→ better regulate and reduce para-fiscal charges.

Education and innovation

The education system faces a number of structural challenges. Serbia's population is ageing and shrinking by around 0.5 % per year. Public spending on education as a percentage of GDP is comparable to that of EU countries, but outcomes in terms of skills and key competences are weaker. Serbia ranked below all EU Member States in the 2017 World Economic Forum human capital index, with particularly weak results in the 15-24 age group. The level of research investment is below 1 % of GDP and cooperation between researchers in the public and private sector is not systematically supported.

The quality, equity and relevance of education and training have to be improved in order to better match societal needs. Both employers and graduates believe that the country's education institutions do not equip students with key soft skills, such as problem solving and decision-making. National strategic documents and recently adopted legislation aim to address the outdated curricula and obsolete teaching methods in pre-university education; however, the implementation is yet to follow. The Law on national qualifications framework has been adopted and should now be linked with a progressive reform of the education system at all levels, including non-formal and informal learning.

Physical capital and quality of infrastructure

The stock and quality of infrastructure is poor and below the economy's needs. The share of total investment in the economy is low at below 20 % of GDP. Work on major infrastructure projects intensified in recent years but the level of public investment remained suboptimal. Foreign direct investment has been on the rise in the last three years, staying above 5 % of GDP. A large share of it was channelled into greenfield projects in tradable sectors, thus further increasing the production and export base.

Structural reforms in the transport and energy sectors could support new investment. In order to ensure efficient use of public resources, the investment appraisal, implementation, and monitoring processes need to be further strengthened. The transport and energy sectors require improvement in traffic management, maintenance and road safety, and in energy efficiency and diversification. Information and communication technology infrastructure continued to expand. Almost two thirds of households have internet access at home and the use of online public services increased. The authorities have made digitalisation one of their top priorities.

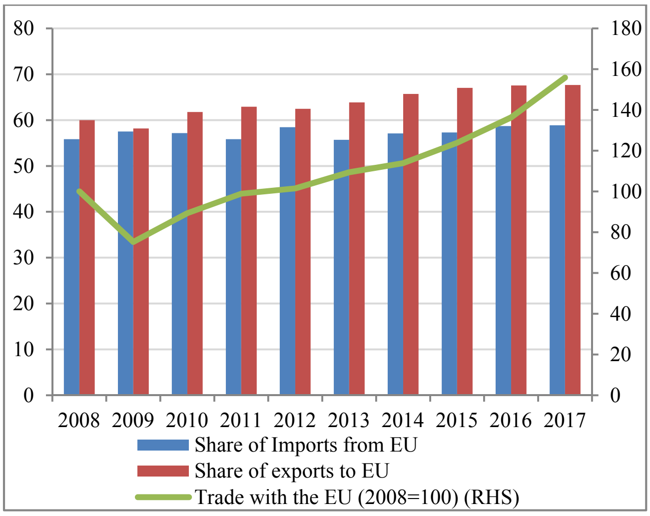
Sectoral and enterprise structure

The structure of the economy continued to change incrementally. Due to its high dependency on weather conditions, agricultural performance was volatile. Nevertheless, its share of GDP has fallen for several years in a row, confirming a shift in economic activity towards other sectors. However, at 6.5 % of GDP and close to a fifth of total employment, agriculture is still relatively important in comparison to peer countries. Services and industry remained dominant in the economy, both in terms of value added — with shares of slightly above half and one fifth of GDP respectively — and employment. The recent influx of foreign direct investment helped reviving manufacturing activity. However, some of the foreign investments benefit from state aid and remain technologically less sophisticated. Further, sustained investment in industry and manufacturing is needed to safeguard and upgrade skills, improve productivity and ensure the integration of a larger number of domestic firms into cross-border value chains.

Horizontal support to small and medium-sized enterprises increased. Small and medium-sized enterprises (SMEs) are particularly active in construction, retail and tourism services. In order to further encourage SME development, the government extended the activities of the 2016 Year of Entrepreneurship to the whole decade and is providing various programmes of financial and non-financial assistance to the sector. Nevertheless, SMEs face a number of challenges, including an unpredictable business environment, and are most vulnerable to the high and unpredictable para-fiscal charges. Despite recent improvements, access to finance also remains difficult and costly.

Economic integration with the EU and price competitiveness

Figure 4.5. Serbia trade integration with the EU



Source: Eurostat, national sources

Economic integration with the EU increased further. Trade openness rose above 110 % of GDP in 2017 as both imports and exports grew by double digits in euro terms. The EU is by far Serbia's main trading and investment partner, accounting for around two thirds of total trade and more than three quarters of net foreign direct investment inflows. It is followed by the Central European Free Trade Agreement (CEFTA) countries, which represented around a fifth of exports but less than 5 % of total imports last year. The development of a Regional Economic Area based on EU rules and standards, to which all Western Balkan economies have committed, has the potential to generate untapped growth. The national quality infrastructure still does not fully support trading operators and there are non-tariff barriers impeding intra-regional trade as well as the trade with the EU. Better services could be offered to support the internationalisation of companies, in particular SMEs, and to bring domestic and foreign companies together. The dinar appreciated against all major currencies in 2017, reducing price competitiveness. However, non-price competitiveness improved further due to rising foreign direct investment in tradable sectors.

4.3. CONCLUSIONS

As regards the economic criteria, Serbia has made good progress and is moderately prepared in developing a functioning market economy. Some of the policy weaknesses, in particular with regard to the budget deficit, were addressed. Growth fundamentals are sound and macroeconomic stability was preserved. Inflation was contained and monetary policy supported growth. Labour market conditions improved further. However, government debt is still high and the budgetary framework and its governance need to be strengthened. Major structural reforms of the public administration, the tax authority, and state-owned enterprises remain incomplete. Informal employment, unemployment and economic inactivity remain still very high, particularly among women and youth. The private sector is underdeveloped and hampered by weaknesses in the rule of law and the enforcement of fair competition.

Serbia is moderately prepared to cope with competitive pressure and market forces within the Union. Some progress was made to increase competitiveness. However, the level of investment activity is still below the economy's needs. Despite some improvements, companies face a number of challenges, including an unpredictable business environment, a high level of para-fiscal charges, and difficult and costly access to finance.

5. TURKEY

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the EU.

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. Each enlargement country prepares an Economic Reform Programme (ERP) annually, which sets out a medium-term macro-fiscal policy framework together with a key structural reform agenda aimed at ensuring competitiveness and inclusive growth. These ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

5.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

The Turkish economy is **well advanced** and can be considered a functioning market economy. The economy supported by government stimulus measures, managed to recover from the contraction witnessed in the wake of the attempted coup of 2016 and achieved strong growth in 2017. However, high growth is coupled with significant macroeconomic imbalances. The current account deficit remains high and increased towards the end of 2017, making the country dependent on capital inflows and vulnerable to external shocks. Inflation moved to double-digit rates in 2017, and the depreciation of the Turkish lira continued, highlighting concerns over the degree of commitment of monetary policy decision-makers to price stability. The tendency to increase state control in the economic sphere and the actions targeting companies, businessmen and political opponents and their businesses harmed the business environment. Overall, there was **backsliding** in this area.

In order to support long-term growth, Turkey should pay particular attention to:

→ reduce macroeconomic imbalances by promoting domestic savings;

→ achieve a more inclusive labour market, increasing flexibility and reducing informality;

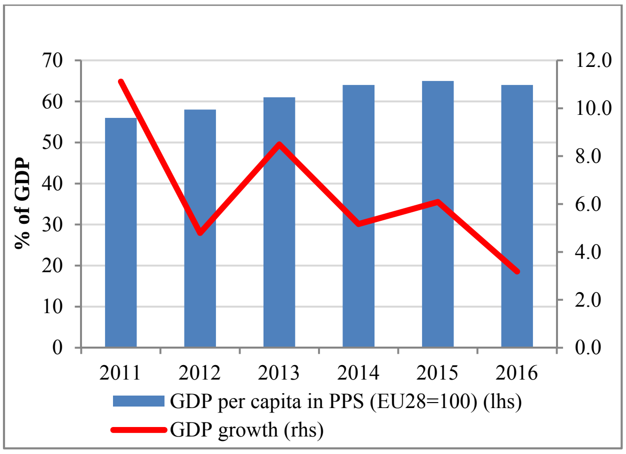
→ improve the business environment, including by strengthening the rule of law and the judiciary.

Economic governance

Although still considered a functioning market economy, Turkey has been backsliding in its commitment to market-oriented approaches, with a deteriorating business environment and widening macroeconomic imbalances. There was only limited implementation of the policy guidance jointly adopted in May 2017. The government's Economic Reform Programme for 2018-2020, submitted to the Commission in January 2018, projects an optimistic macroeconomic scenario in which GDP growth continues at a high pace and investment increases while unemployment, inflation, the government deficit and the current account deficit decrease. In July 2017, a cabinet reshuffle strengthened economic management by concentrating the coordination of economic policy in the hands of the Vice Prime Minister responsible for the Treasury. At the same time, targeted government action against companies, business people, political opponents and their businesses and the large-scale dismissal of judges and prosecutors continued. This further negatively affected the business environment. Uncertainty over the central bank's independence in carrying out monetary policy increased, to the detriment of macroeconomic stability.

Macroeconomic stability

Figure 5.1. Turkey GDP growth



Source: Eurostat, national sources

Economic growth rebounded after the coup attempt. Following an average growth rate of 7.4 % from 2010 to 2015, domestic political uncertainty, geopolitical conflicts and security concerns led to an economic slowdown in the second half of 2015. High loan growth driven by government credit guarantees and macro-prudential measures, a waiver for employers' social contributions and other policy measures, the depreciation of the lira, strong growth in the construction sector, and the upswing in the European economy have contributed significantly to reviving the economy. Turkey recorded an average growth rate of 6.4 % year-on-year (2.4 % quarter-on-quarter) in the four quarters to September 2017. The high contribution from the construction industry to recent economic growth and the upward revision of GDP levels by 20 % under the new national accounting methodology complicate estimates of Turkey's sustainable economic growth rate. This is particularly true in a context of high inflation, a depreciating trend in the Turkish lira, high credit and money growth, and high unemployment. GDP per capita in purchasing power standard increased from 58 % of the EU average in 2012 to 64 % in 2016.

Table 5.1: **Turkey - Main economic trends**

		2012	2013	2014	2015	2016	2017
Gross domestic product	Ann. % ch	4.8	8.5	5.2	6.1	3.2	7.4
Private consumption	Ann. % ch	3.2	8.0	2.9	5.4	3.6	6.2
Gross fixed capital formation	Ann. % ch	2.7	13.8	5.1	9.3	2.2	7.3
Unemployment rate	%	8.3	8.9	10.1	10.5	11.1	11.1
Employment	Ann. % ch	3.1	2.8	1.6	2.5	2.2	3.5
Wages (hourly, manufacturing, index)	Ann. % ch	11.5	12.4	14.2	14.9	18.4	12.4
Current account balance**	% of GDP	-6.1	-7.8	-4.7	-3.8	-3.8	-5.5
Direct investment (FDI, net)**	% of GDP	1.7	1.4	1.4	2.1	1.6	1.3
CPI, average	Ann. % ch	8.9	7.5	8.9	7.7	7.8	11.1
Exchange rate TRY/EUR, average	Value	2.31	2.57	2.90	3.03	3.34	4.15
General government balance	% of GDP	-0.4	0.1	0.1	1.3	-0.9	-2.4f
General government debt	% of GDP	32.6	31.3	28.6	27.5	26.4	28.2f

** refers to a 4 quarters moving average.
Source: Macrobond, Eurostat

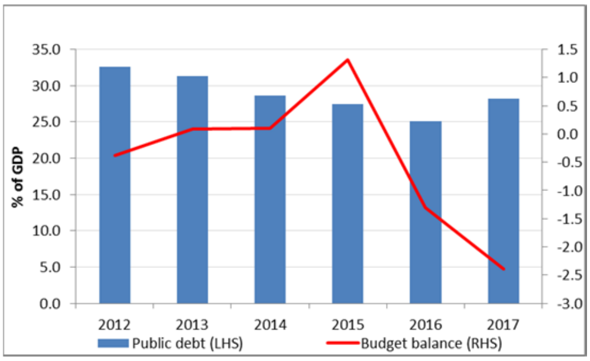
Turkey's current account deficit has stopped narrowing in recent years and widened in 2017. The deficit declined from 7.7 % of GDP in 2013 to 3.7 % in 2016, supported by declining oil prices and the depreciation of the Turkish lira. However, it increased during 2017 to 4.5 % of GDP on a 12 month rolling basis in 2017 Q3. Political uncertainty following the attempted coup, combined with regional instability and bilateral crises (in particular with Russia), had a negative impact on trade revenues and on foreign direct investments (FDI). Most capital inflows tend to be portfolio investments. FDI inflows to Turkey declined sharply by 30.5 % to approximately 1.5 % of GDP in 2016. Dependence on volatile capital inflows makes the Turkish currency and economy vulnerable to a sudden loss of investors' confidence. Gross external debt stock as a percentage of GDP increased to 46.9 % in 2016, most of which is owed by the private sector.

Domestic savings have been revised upward under the revised national accounting methodology but still fall well short of domestic investment. The shortfall in domestic savings needs to be compensated with inflows of foreign capital. In order to promote domestic savings, private pension savings were subsidised and the Treasury started to issue gold-denominated bonds and lease certificates.

Inflation remained high and Turkey faced the return of double-digit inflation for the first time since 2012. The rise in food and energy prices and the depreciation of the Turkish lira put pressure on inflation in 2017, which was the first year to have a double-digit average headline (11.1 %) and a double-digit core inflation rate (10.1 %) since 2003, when the central bank regained control over inflation. High inflation has significant costs in terms of macroeconomic stability, resource allocation and redistributive effects. It also risks eroding the credibility of the central bank and reducing monetary policy's effectiveness.

The central bank continued to pursue multiple objectives as part of an overly complex monetary policy framework in a context of challenges to its independence. Although price stability is the primary objective, the central bank is also pursuing macro-financial stability and trying to dampen exchange rate fluctuations. Together with political calls for lower interest rates and question marks over the usefulness of an independent monetary policy, this has led to uncertainty in financial markets and, as a result, a volatile exchange rate. The 'Late Liquidity Window', the monetary policy for providing liquidity to banks in exceptional circumstances has become the only policy tool as of November 2017. Monetary policy should focus more on its primary objective of price stability in order to reach the official inflation target. In addition, simplifying the monetary policy framework would improve its transparency and predictability, and would strengthen the central bank's credibility.

Figure 5.2. Turkey fiscal developments



Source: Eurostat, national sources, ESA2010 till 2015

Stimulus measures have led to deteriorating public finances and a rise in contingent liabilities. The government has benefited from lower interest payments and the primary deficit has decreased to close to zero in recent years. At the same time, contingent liabilities to government finance have built up in the banking sector, from public-private partnerships and from government guarantees for the KGF credit fund. Government debt exceeded the legal limit set for 2017 by the end of the first eight months of the year. The borrowing limit was increased by the Parliament a first time by 5% and by an additional 5% in October 2017. The Parliament also added TL 37 billion to the net borrowing amount. The 2016 central government budget deficit amounted to 1.1 % of GDP, which is marginally lower than in the preceding year (1.2 %) and in the originally planned budget (1.6 %). Revenues increased by 14.8 % year-on-year, while expenditure increased by 15.3 %. Budgetary figures look more positive under the revised national accounting methodology. In 2017, government revenues increased by 13.8 % year-on-year and government expenditure increased by 16.0 %. The general government debt stock remained at a sustainable level. General government debt as a percentage of GDP increased from 27.5 % in 2015 to 28.1 % in 2016. Taking account of wider macroeconomic issues, however, Turkey's fiscal policy stance has not appropriately addressed the country's persistent external imbalance in recent years. Public finances have a significant role to play in increasing overall domestic saving and reducing the need for capital inflows through an appropriately tight fiscal policy stance.

Turkey made some progress in increasing the transparency of its fiscal framework. As of December 2016, key budget documents (with the exception of the pre-budget statement) are made publicly available online within a period that is consistent with international standards.

Functioning of product markets

Business environment

Starting a business has become easier. The number of procedures to start a company has been reduced by one to seven, now taking 6.5 days instead of 7.5 days. Obtaining construction permits is still burdensome, but the costs for registering the transfer of property have been lowered. The number of company bankruptcies decreased by 8.9 % year-on-year in 2016 but it increased by 22.5 % in 2017. The number of newly created businesses decreased by 4.5 % in 2016, but increased by 14.4 % in 2017. As a consequence, the net creation rate of companies was negative 3.5 % year-on-year in 2016, but turned to a positive rate of 12.7 % year-on-year in 2017.

Market exit remained costly and time-consuming. Insolvency procedures lasted an average of five years and recovery rates fell further, to an average of 15.3 %. Resolving insolvency became more difficult as applications to postpone bankruptcy procedures made before and during the state of emergency were suspended.

Targeted actions against media companies, business people and political opponents critical of the government had a negative effect on the overall business environment. The management of numerous companies has been transferred under the trusteeship of the Savings Deposit Insurance Fund (TMSF). As of 1 February 2018, 985 companies across Turkey, with a total value of assets of TL 47.6 billion (EUR 9.7 billion) and with a total of 49 587 employees, have been seized or have been moved under trusteeship following the attempted coup. The January 2017 introduction of a new communiqué law grants the minister in charge of the TMSF the power to decide on the sale and dissolution of companies transferred to the TMSF and to lay down implementing rules for their management. Trustees assigned to the transferred companies are immune from administrative, financial and criminal liability.

There has been serious backsliding in the past year with regard to the judicial system. Continued political pressure on judges and prosecutors and collective dismissal of a large number of judges and prosecutors following the 2016 attempted coup had a significant negative effect on the independence and the overall quality and efficiency of the judiciary. A reasonably well-functioning legal system continues to be in place with regard to property rights**.** Although the introduction in 2015 of an electronic filing system for court users made enforcing contracts easier, the enforcement of commercial contracts remains a lengthy process that took an average of 580 days in 2016. Turkey ranked 107th out of 138 countries with regard to judicial independence, according to the World Economic Forum’s 2016-2017 Global Competitiveness Report. Turkey also scores poorly on the efficiency of the legal framework in settling disputes, ranking 96th. From 2015 to 2017, Turkey dropped from 80th (out of 102 countries) to 101st position (out of 113 countries) in the World Justice Project’s Rule of Law index.

State influence on product markets

The state is still active in price setting in key sectors. More than 25 % of the consumer price inflation basket in Turkey is composed of goods whose prices are either set or heavily influenced by the public authority either directly or indirectly (price limits, adjusting tax rates). This practice, which changes relative prices outside of market forces, is mostly driven by other economic concerns such as the current account balance and limiting the pass-through of foreign currency denominated prices. The Food and Agricultural Product Markets Monitoring and Evaluation Committee is seeking to contain the rise in the food prices by taking measures to improve supply conditions for unprocessed food products. For energy (natural gas and electricity), the government continued to set end-user prices, effectively suspending automatic pricing mechanisms. A transparent and cost-based pricing mechanism for the electricity and gas sectors has not yet been properly implemented.

There was no progress in improving the transparency of state aid. Legislation to implement the State Aid Law, originally scheduled to be passed by September 2011, has still not been adopted. The State Aid Authority has still not formally set up a comprehensive state aid inventory or adopted an action plan to align all state aid schemes, including the 2012 incentives package, with the *acquis*. On 5 December 2017 provision of the Law Monitoring and Supervision of the State Aid related to the enforcement of implementing legislation was amended. The amendment, repealing the set of previously defined deadlines without introducing a new one, enabled the Council of Ministers to delay the enforcement of the implementing legislation for an unlimited period and caused a strong deterioration of Turkey's determination on aligning its State Aid legislation with the related EU *acquis.*

Privatisation and restructuring

The pace of privatisation slowed down further. Following a surge in 2013, privatisation activities slowed down, with the total volume of completed deals decreasing from EUR 1.8 billion in 2015 to EUR 1.2 billion in 2016. Continued liberalisation in the markets for goods and services could improve competition.

In 2017, a large proportion of state assets were transferred to the Turkish Sovereign Wealth Fund (TWF). This was set up in August 2016 to provide funding for large-scale infrastructure and real estate projects in Turkey. The states assets concerned are predominantly the shares previously held by the Treasury of large companies and banks (such as Ziraat Bankası, Halkbank, Borsa Istanbul, Türk Telekom, THY, PTT, TÜRKSAT, BOTAŞ, Eti Maden and Çaykur). While these assets are not subject to any inspection, audit or monitoring by the Court of Accounts, every action taken by the fund will be reported directly to the Prime Ministry. In January 2018, an emergency decree was issued that allows foreign borrowing by the TWF against its assets.

Functioning of the financial market

Financial stability

The financial sector performed well and continued to demonstrate resilience. The sector's capital adequacy ratio remained unchanged compared to 2015, at 15.6 % in 2016, and increased to 16.9% in 2017. It continues to be well above the regulatory target of 12 %. The proportion of non-performing loans of total banking sector loans slightly increased, from 3.1 % in 2015 to 3.2 % in 2016, but declined in 2017 as loan growth outpaced non-performing loans growth (2.9 % in December 2017). The banking sector's loans-to-deposits ratio has gradually increased to 126 % in 2017. The gap left by a lack of domestic deposits was funded from abroad, mostly by long-term financial instruments (bonds, deposits, loans) and financial instruments denominated in Turkish lira. The liquidity ratio of Turkish banks is below 100% for maturities between 7 days and 3 months and funded for half by derivatives (predominantly swaps). This may expose Turkish banks to counterparty risks, in particular in the case of exceptional events.

Access to finance

Banks continued to dominate the financial sector. Their rapid credit expansion continued in 2017, with total bank lending increasing by 22 % year-on-year. The value of the banking sector's assets as a ratio of GDP fell from 121 % in 2015 to 105 % in 2016. The size of the much smaller insurance sector (including private pensions) increased to 4 %. State-owned banks' proportion of total banking sector assets slightly increased to 34 % as of September 2017, while the proportion owned by foreign banks increased to 27 %.

Functioning of the labour market

Figure 5.3. Unemployment in Turkey (% of Active population)

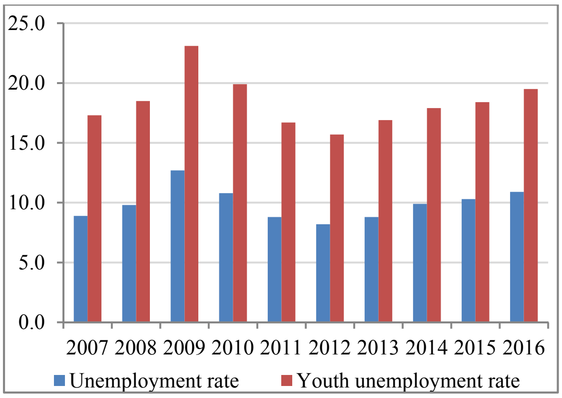
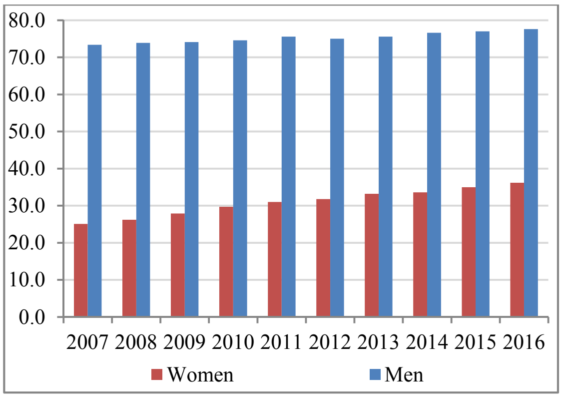


Figure 5.4. Participation rates in Turkey (% of Labour Force)



Source: Eurostat, national sources

Unemployment remained high despite strong economic growth and government incentives. The employment mobilisation campaign launched in 2017 seems to have had a limited impact. In 2016, the unemployment rate (for 15-64-year-olds) stood at 10.9 %, representing an increase of 0.6 percentage points compared to 2015. Labour force growth is driven by a growing number of people of working age, as well as a rising labour force participation rate (up from 56.1 % in 2015 to 57 % in 2016). The overall employment rate increased from 53.9 % in 2015 to 54.3 % in 2016 with a large difference between men (75.5 %) and women (33.2 %). Turkey needs to focus on achieving a more inclusive labour market by increasing flexibility and reducing informality. The unemployment rate for people with higher education level reached 12.2 % in November 2017.

5.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE EU

Turkey has made **some progress** and has a **good level of preparation** to cope with competitive pressures and market forces within the EU. Turkey is well-integrated with the EU market in terms of both trade and investment. Some progress was made in the energy sector, particularly in the gas market, and in increasing R&D spending. However, significant problems remained with regard to the quality of education. There was no progress in improving the transparency of state aid.

In order to support long-term growth, Turkey should in particular:

→ raise the quality of the education system;

→ improve qualifications for low-skilled workers through training;

→ increase research and development capacity.

Education and innovation

According to the most recent PISA([1]) study on the educational performance of 15-year-old students, Turkish students' performance fell in all three subjects tested (science, mathematics and reading) between 2012 and 2015. The measures taken by the government following the attempted coup in 2016 resulted in a considerable number of staff dismissals and changes in educational institutions, posing risks to the stability of Turkey's education sector. The continuous changes occurring in the education system also create an uncertain environment for both students and teachers.

A mismatch continues to exist between the requirements of the labour market and the skills produced by the education system. Turkey needs to make better use of its human capital to stimulate sustainable and inclusive growth and competitiveness, both through raising the level of qualifications for the workforce and creating a stable and solid framework for the education system.

Public and private sector research and development (R&D) expenditure slightly increased from 0.86 % of GDP in 2014 to 0.94 % in 2016, though it remained well below the government's current target of 1.8 % by 2018. About half of this investment came from the private sector. The Production Reform Package adopted in July 2017 contains measures to encourage R&D activities in universities and to strengthen cooperation between higher education institutions and the public and private sectors. However, intensified efforts are needed to develop a comprehensive strategy to support R&D, while building closer cooperation between research institutions and businesses.

Physical capital and quality of infrastructure

The estimate of gross fixed capital formation in the economy has increased significantly under the revised national accounting methodology. By far the largest proportion of this increase is attributable to an increase in construction investment. Total investment declined by 0.2 percentage points to 28.2 % of GDP in 2016. The share of private investment in GDP decreased slightly from 24.2 % to 24.1 % and the share of public investment of GDP fell slightly from 4.2 % to 4.1 % between 2015 and 2016.

Turkey has undertaken sizeable investments in its infrastructure in the past decade and almost all provincial centres are now connected by dual carriageways. Major infrastructure works were completed and opened to traffic in 2016, such as the Eurasia tunnel under the Bosphorus and the third bridge over the Bosphorus. In relation to telecommunications, the number of internet subscribers increased by 28.1 % in 2016 and the internet penetration rate for households increased from 59.6 % in 2015 to 61.5 % in 2016 and to 66.8% in 2017.

Some progress was made in the energy sector, particularly in the gas market. New implementing regulations on tariffs and organised wholesale markets are expected to further improve existing tariff methodology and to establish a fair and transparent platform for gas traders. Turkish Electricity Transmission Company (TEİAŞ) has been an observer at the European Network of Transmission System Operators for Electricity (ENTSO-E) since 2016, allowing market players to freely import and export electricity between the EU and Turkey and thus improving the security of supply. Although the Turkish Energy Stock Company (EPIAS) became fully operational in 2016, progress on creating a competitive and transparent energy platform has remained rather limited. Further progress is needed to open the natural gas market and create competition for the state-owned corporation BOTAŞ.

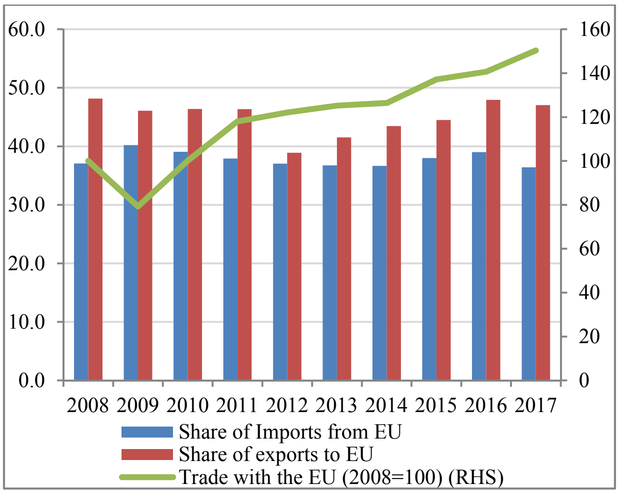
Sectoral and enterprise structure

In 2016, GDP grew by 3.2 %, while employment increased by just 2.2 %, indicating an increase in labour productivity in the overall economy. The sectoral breakdown of employment growth shows a continued

([1]) OECD's Programme for International Student Assessment shift towards the services sector, which accounted for 53.7 % of employment (and 62.3 % of GDP) in 2016. Industry (including construction) accounted for 26.8 % of employment (and 19.6 % of GDP). Agriculture employed 19.5 % of the workforce and its proportion of GDP decreased from 6.9 % in 2015 to 6.2 % in 2016. Small and medium-sized enterprises (SMEs) employ around three quarters of Turkey's work force and generate more than half of the economy's total value. In exports, Turkey has specialised in low-to-medium tech in its exported goods. The largest proportion of exports is provided by the automotive sector. The increased demand from, in particular, the EU has benefited Turkish exporters in recent years.

Economic integration with the EU and price competitiveness

Figure 5.5. Turkey trade integration with the EU



Source: Eurostat, national sources

Turkey's trade and economic integration with the EU is high and increased further in 2016 and 2017. Turkey is the EUs fifth largest trade partner and the EU remains by far Turkey's largest trade partner. In absolute terms Turkey's trade with the EU further increased in 2017, even if in relative terms the share of Turkish exports going to the EU and Turkish imports coming from the EU decreased from 48 % to 47.1% and from 39 % to 36.4 % between 2016 and 2017, respectively. The EU also remains the largest source of FDI into Turkey with a 73 % share of FDI stocks in Turkey in 2016. **FDI flows from the EU into Turkey dropped exceptionally sharply** from a historic high of EUR 11.9 bn in 2015 to EUR 0.3 bn in 2016. Turkey's international price competitiveness improved slightly in 2016 and strongly in 2017 as a consequence of the depreciation of the lira outpacing the rise in the price level. Nonetheless, competitiveness based on wage levels did not improve over these two years due to increases in the real wage following a 30 % increase in the statutory minimum wage in 2016.

5.3. CONCLUSIONS

Regarding the economic criteria, the Turkish economy is well advanced and can be considered a functioning market economy. The economy supported by government stimulus measures, managed to recover from the contraction witnessed in the wake of the attempted coup of 2016 and achieved strong growth in 2017. However, high growth is coupled with significant macroeconomic imbalances. The current account deficit remains high and increased towards the end of 2017, making the country dependent on capital inflows and vulnerable to external shocks. Inflation moved to double-digit rates (11.1 %) in 2017, and the depreciation of the Turkish lira continued, highlighting concerns over the degree of commitment of monetary policy decision-makers to price stability. Turkey's economy continued to be characterised by a high level of informality. Overall, there was backsliding in this area. The tendency to increase state control in the economic sphere and the actions targeting companies, businessmen and political opponents and their businesses harmed the business environment.

Turkey has made some progress and has a good level of preparation to cope with competitive pressures and market forces within the EU. Turkey is well-integrated with the EU market in terms of both trade and investment. Some progress was made in the energy sector, particularly in the gas market, and in increasing research and development spending. However, significant problems remained with regard to the quality of education. There was no progress in improving the transparency of state aid.

6. BOSNIA AND HERZEGOVINA

In line with the conclusions of the June 1993 European Council in Copenhagen, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. Each enlargement country prepares an Economic Reform Programme (ERP) annually, which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU, the Western Balkans and Turkey at ministerial level in May each year.

6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Bosnia and Herzegovina has made **some progress**, but is still at **an early stage** of establishing a functioning market economy. Some improvements of the business environment have been achieved and the financial sector has been strengthened. Key remaining issues are a weak rule of law, a still poor business environment, a fragmented and inefficient public administration and major labour market imbalances, related to a poor education system, weak institutional capacities, and an unsupportive investment climate.

In order to support long-term growth, Bosnia and Herzegovina should pay particular attention to:

→ strengthen the political ownership of reforms and the cooperation and coordination among different levels of government;

→ improve the quality of public finances by strengthening its growth-friendliness and improving the targeting of social spending;

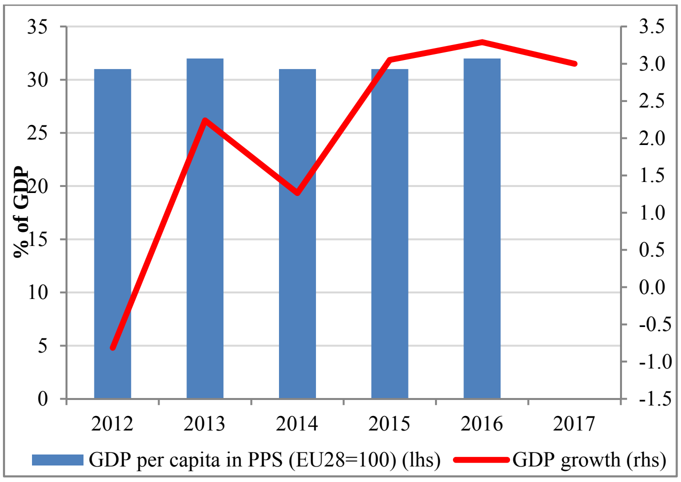
→ improve the provision and quality of timely and exhaustive statistics, increasingly applying European and international standards.

Economic governance

The consensus on economic policy essentials has been impeded by frequent political stalemates and a lack of political ownership. Despite general acceptance of the main principles of a marked-based economy, frequent short-term oriented political disputes have resulted in delays and interruptions of agreed and long overdue reform projects. 2017 has been particularly affected in this respect. Following progress up to early 2017, a major reform package, the Reform Agenda experienced a substantial slowdown during most of 2017. Also, the implementation of a 3-year arrangement agreed with the IMF in September 2016 faced significant delays during the year. However, in late 2017 and early 2018 the country adopted measures, such as amendments to a set of excise laws, which allowed the completion of the first review of the IMF programme in early 2018. There was only limited implementation of the policy guidance jointly adopted in May 2017. The submission of the 2018 ERP was delayed and the document points to significant weaknesses in administrative coordination and cooperation and policy formulation.

Macroeconomic stability

Figure 6.1. Bosnia and Herzegovina GDP growth



Source: Eurostat, national sources

Economic growth remained stable, but below the country's potential. Economic output growth remained resilient, expanding by some 2.5 % on average annually over the last 5 years. The main growth driver has been domestic demand, in particular private consumption, largely thanks to a stable inflow of workers remittances and low inflation, supporting real disposable income. In 2017, external demand provided an additional boost. Domestic and foreign investment have remained subdued, reflecting a poor business environment and high political uncertainties. *Per capita* GDP([2]) stood at some 32 % of the EU-28 average in 2016, only slightly up from 31 % in 2012.

External imbalances have declined further, benefiting from stronger external demand. The current account deficit narrowed sligthly from 5.1 % of GDP in 2016 and to 4.7 % in the four quarters to September 2017, benefiting from rapidly strengthening exports, lower import prices and stronger tourism. However, higher consumption-driven imports kept the trade deficit at 23.6 % of GDP in the four quarters to September 2017. The substantial trade deficit has still been largely financed by inflows of transfers, such as remittances. Net foreign direct investments increased slightly, reaching 2.2 % in the four quarters to September of 2017. Net foreign exchange reserves rose to about 32 % of GDP.

Table 6.1: **Bosnia and Herzegovina - Main economic trends**

		2012	2013	2014	2015	2016	2017
Gross domestic product	Ann. % ch	-1.2	2.6	0.2	3.8	3.3	1.6
Private consumption	Ann. % ch	2.2	2.7	2.7	1.3	1.3	2.0 Q2
Gross fixed capital formation	Ann. % ch	6.3	-1.2	11.5	-3.5	2.5	n.a
Unemployment rate	%	28.2	27.5	27.5	27.7	25.4	20.5
Employment	Ann. % ch	-0.4	1.0	-1.2	1.2	-2.6	1.8
Wages	Ann. % ch	1.5	0.1	-0.1	0.0	0.9	1.6
Current account balance**	% of GDP	-8.7	-5.0	-7.1	-5.2	-4.7	-4.7
Direct investment (FDI, net)**	% of GDP	1.9	1.2	2.8	1.6	1.5	2.1
CPI, average	Ann. % ch	2.0	-0.1	-0.9	-1.0	-1.1	1.2
Exchange rate BAM/EUR	Value	1.96	1.96	1.96	1.96	1.96	1.96
General government balance	% of GDP	-2.0	-2.0	-2.0	0.6	1.2	n.a
General government debt	% of GDP	36.6	35.5	40.1	40.4	39.1	n.a

** refers to a 4 quarters moving average.
Source: Macrobond, Eurostat

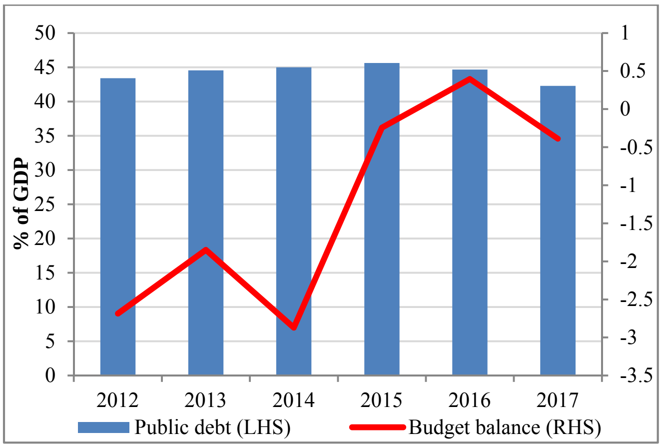
The monetary policy regime has supported stability. The currency board arrangement with the euro as the anchor currency was maintained. This approach has served the economy well so far. However, it also implies that the burden of adjustment to external shocks has to be accommodated by other policy areas, in

([2]) Expressed in purchasing power standards.

particular responsible fiscal policy, necessitating the building-up of sufficient fiscal buffers and a stronger emphasis on medium-term stability, and structural reforms to improve the functioning of markets.

The overall level of consumer price started to increase during 2017, increasing by 1.2 % on average for the full year. In the two previous years, consumer prices had been slightly declining (-1.1 % and -1.0, respectively), mainly as a result of falling import prices and low domestic price pressures. The main driving factors behind the acceleration in headline inflation have been higher prices for food and non-alcoholic beverages.

Figure 6.2. Bosnia and Herzegovina fiscal developments



Source: Eurostat, national sources

The general government accounts registered slight surpluses, while the quality of fiscal governance has remained low. During 2017, public finances benefited from solid recorded revenue growth, reflecting stable output growth but also measures to improve tax collection. At the same time, spending has remained contained, particularly in the area of public sector wages. The level of public investment remained very low, as planned external financing often could not be secured. Despite some progress on improving the financing of the pension system the overall quality of public sector governance remained very low, with substantial spending inefficiencies, particularly in the health sector, and a poor targeting of social transfers. Planned reforms to improve the quality of public spending have been frequently delayed. Public debt declined slightly in 2017, dropping to 38 % of GDP by end-June, partly reflecting difficulties in accessing foreign capital markets.

Overall, the country's macroeconomic policy mix suffers from an insufficient speed in implementing overdue reforms and a lack of medium-term orientation. While macroeconomic stability has been preserved overall, the speed of reform implementation has been clearly too slow to achieve progress that is more noticeable to the country's citizen. The policy mix also lacks medium-term orientation.

Functioning of product markets

Business environment

Market entry and exit regulation has slightly improved, while existing barriers to entering and leaving product markets remain high. Efforts continued to facilitate business registration. Some steps have been taken to strengthen the support for foreign investors. According to international rankings, the business environment has slightly improved, although the overall level is still very low. Compared with other countries, BiH's ranking has slightly deteriorated, reflecting the slow speed in implementing reforms. Overall, the required procedures for entering or leaving the product market are still numerous and lengthy, hampering the country's attractiveness for doing business.

The rule of law and the functioning of the judiciary continue to be a crucial weakness. Improvements in this area have remained very limited. Among other things, there are still issues with contract enforcement, difficulties in settling commercial disputes, a substantial backlog in court cases, and issues with establishing property rights, for example illustrated by a low degree of real estate registration in some areas. The resource endowment and independence of numerous regulatory and supervisory institutions is still insufficient.

The informal economy is still significant, playing a major role in providing (unregistered) employment and income but also in distorting competition and eroding the base for taxation and social security contributions. Despite some limited progress in addressing the informal economy, such as improving the degree of registration in the labour market, the informal sector may still account for some 25 % of GDP. This high level of informal economy requires rates for taxes and social security contributions to be higher than would be otherwise necessary. This also adds to a significant fiscal burden on labour, which in turn impedes formal employment from being created and negatively affects BiH’s international competitiveness.

State influence on product markets

Direct state influence on the economy has remained high. Despite efforts to reduce state influence, public spending still accounts for more than 40 % of GDP, generating about 22 % of the country’s value added and employing about 26 % of the country's labour force. State-owned companies as well as state subsidies and guarantees, which lead to substantial contingent liabilities, are a heavy burden on public finances and thus the country’s tax payers.

Privatisation and restructuring

The privatisation process is still not complete. Attempts to sell earmarked public companies have been largely unsuccessful. Some steps have been taken, such as the initiation of the due diligence procedures for two local telecommunication companies which could lead to privatisation later on. Strategic sectors such as transport, energy (and telecom in the Federation) are still dominated by poorly managed and often inefficient state-owned companies. Proceeding with privatisation could stimulate competition, improve the quality of the provided services and relieve public finances from a recurring burden.

Functioning of financial markets

Financial stability

The financial sector’s stability has slightly improved, but banking sector supervision is still hampered by fragmented competences. Credit risk indicators for the banking system have improved slightly: the ratio of non-performing loans (NPLs) dropped from 11.8 % end-September 2016 to 10 % by end-September 2017, which, however, is still relatively high. The sector’s overall capital adequacy ratio remained largely unchanged at 15.6 % by end-September 2017, well above the country’s regulatory minimum of 12 %. However, there are still some banks with insufficient capital endowment. Newly adopted banking laws should simplify loan restructuring and thus have a positive effect on the financial sector’s stability. Banking sector profitability has been low, but improved during 2017. However, the central bank’s analytical capacities are still limited and financial sector supervision suffers from insufficient inter-entity cooperation.

Access to finance

Bank lending to the private sector has gathered pace. Credit growth accelerated from about 2 % year-on-year in 2016 to 5.3 % in 2017, reaching about 57 % of GDP. The number of banks is high in relation to the market size, although it has fallen to 23 after two small, local banks went bankrupt in 2017. Interest rate spreads have markedly declined for consumer loans, dropping from above 6 percentage points to around 4 percentage points. This probably reflects increased competition and efficiency in the consumer loan sector. However, spreads are still relatively high, suggesting either still high risk-premia and/or a lack of competition.

Functioning of the labour market

The employment situation has slightly improved, although labour market participation is low in general. During 2017, the labour market benefited from stable output growth, active labour market measures and steps to reduce the informal economy. Registered employment was on average 3.1 % higher in 2017 than a year before, compared to an increase by 2.1 % in 2016. The number of registered unemployed has dropped by 6.9 %, compared to a decline by 3.9 % the year before. This implies a decline in the labour force, but also a reduction in the registered unemployment rate to 38.7 %. Significant differences between registered and survey-based figures signal substantial weaknesses in labour market statistics. Furthermore, available data points to demographic issues, as well as weaknesses in the allocation mechanism, alongside shortcomings in education and training.

Figure 6.3. Unemployment in Bosnia and Herzegovina (% of Active population)

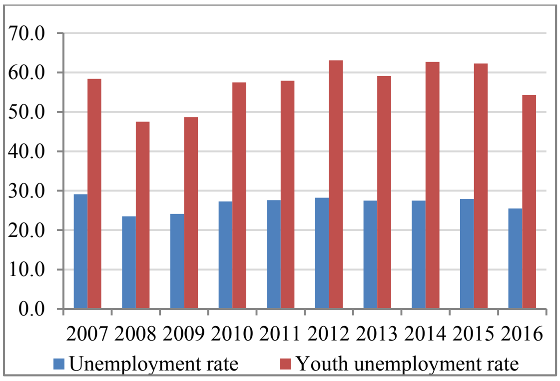


Figure 6.4. Participation rates in Bosnia and Herzegovina (% of Labour Force)

Source: Eurostat, national sources

6.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURES AND MARKET FORCES WITHIN THE UNION

Bosnia and Herzegovina has made **some progress** but remained **at an early stage** in achieving the capacity to cope with competitive pressure and market forces within the Union. The overall level of education and spending on R&D has remained low. The quality of the physical capital suffers from underinvestment. Transport and energy infrastructure is insufficiently developed. The speed of structural adjustment has been slow, although there has been some diversification in the country's regional trade structure.

In order to support long-term growth, Bosnia and Herzegovina should pay particular attention to:

→ improve the quality of education and training;

→ create a single economic space in view of fostering investment;

→ increase the size and efficiency of public investment, especially in infrastructure.

Education and innovation

The overall quality of education remained low, as is spending on education and R&D. The country's education system is very complex and highly fragmented. This results in a lack of common standards for various levels of education, as well as in teacher training and performance evaluation. Teaching curricula are outdated and not aligned with the country's needs leading to wide skills mismatches, a major impediment preventing graduates from entering the labour market. Public sector spending on education appears to stand at some 3.5% of GDP. However, the resulting output is one of the weakest in the region. For example, the country's illiteracy rate of about 2.8 % is one of the highest in the region.

Physical capital and quality of infrastructure

The country's physical capital stock suffers from decades of underinvestment. Public and private spending on improving the country's capital stock remained very low in recent years. Despite political commitments to raise investment, public investment has suffered from a prioritisation of consumption and transfer payments while private investment is impeded by slow progress in improving the business environment. This hinders improving the growth potential and labour productivity, impeding efforts to improve income levels and living standards. The country's digitalisation is still at a very low level.

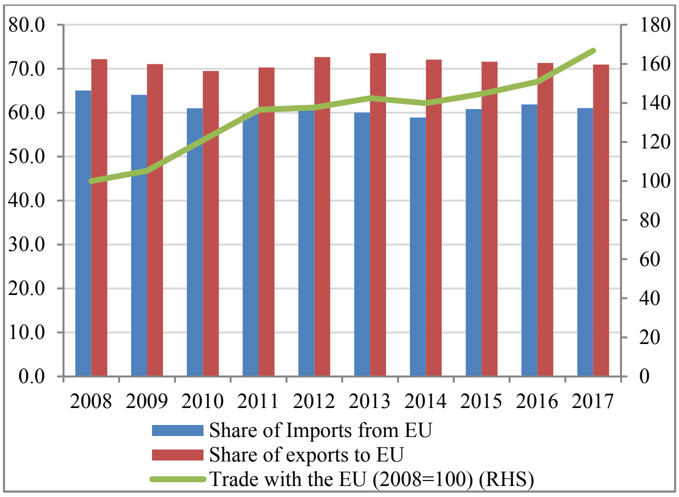
Transport and energy infrastructure remains insufficiently developed. Necessary investment is delayed by a lack of coordination and cooperation between government levels, by financial constraints due to delays in securing agreed external financing and by the absence of a single or harmonised legal and regulatory framework. The markets for electricity and gas remain fragmented and dominated by key incumbent companies. The natural gas sector is regulated at entity level which impedes the development of adequate regulation and a common market.

Sectoral and enterprise structures

The country's economic structure has changed very little. During the last five years, there seems to have been remarkably little change in the sectoral structure of the economy. However, lack of information on the informal sector might mask important changes. The company structure is dominated by small and micro businesses, with companies of less than 50 employees accounting for 93 % of all companies. Their access to bank lending remains difficult. Support schemes are in place for small and medium-sized enterprises, but they are very cumbersome to implement.

Economic integration with the EU and price competitiveness

Figure 6.5. Bosnia and Herzegovina trade integration with the EU



Source: Eurostat, national sources

Trade with neighbouring countries increased markedly, while trade integration with the EU remained high. The trading structure has become more diverse, with an increasing share of trade with neighbouring countries, such as Croatia and Slovenia and Serbia as well as with Turkey. Exports to the EU-28 accounted for 71.8 % of total exports in 2017. The country's openness to trade is relatively low for the country's limited economic size, with exports and imports accounting for some 90 % of GDP. The range of export commodities is not very sophisticated. While limited progress has been achieved in addressing non-tariff barriers to trade with the EU, such as required sanitary standards, overall compliance with these requirements remains a problem.

Nearly 63 % of the country's stock in FDI is originating from EU countries. Annual FDI inflows largely show a similar pattern.

The development of a Regional Economic Area based on EU rules and standards, to which all Western Balkan economies have committed, has the potential to generate untapped growth.

6.3. CONCLUSIONS

Concerning the economic development and competitiveness, Bosnia and Herzegovina has made some progress, but is still at an early stage of establishing a functioning market economy. Some improvements of the business environment have been achieved and the financial sector has been strengthened. Key remaining issues are a weak rule of law, a still poor business environment, a fragmented and inefficient public administration and major labour market imbalances, related to a poor education system, weak institutional capacities, and an unsupportive investment climate. Moreover, the informal economy remains significant.

Bosnia and Herzegovina has made some progress and remained at an early stage in achieving the capacity to cope with competitive pressure and market forces within the Union. The overall level of education and spending on research and development has remained low. The quality of the physical capital suffers from underinvestment. Transport and energy infrastructure is insufficiently developed. The speed of structural adjustment has been slow, although there has been some diversification in the country's regional trade structure.

7. KOSOVO*

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should also be seen in the context of the central importance of economic governance in the enlargement process. Each enlargement country prepares an economic reform programme (ERP) annually, which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

7.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Kosovo has made **good progress** and is at an **early state** of developing a functioning market economy. The business environment has improved and the government adhered to the fiscal rule on budget deficit; however, war veterans' benefits continue to pose a challenge for public finances. The informal economy remains widespread. The increase in the labour force participation rate was not matched by gains in employment so the unemployment rate increased further. It particularly affected women and young and unskilled workers. Despite strong export growth the high trade deficit reflects a weak production base.

In order to support long-term growth, Kosovo should pay particular attention to:

→ enhancing fiscal stability and improving the efficiency of public spending;

→ addressing the underlying legal and institutional factors hampering access to finance for businesses;

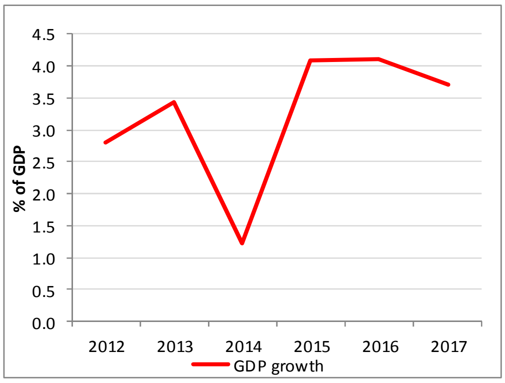
→ enhancing labour market participation and employment, in particular for women and youth.

Economic Governance

The government's strategic documents give priority to fiscal stability and a broad reform agenda, but reform implementation remains a concern. After the parliamentary elections in June 2017, the new government committed to improving economic growth and promoting development, with a focus in particular on manufacturing, processing and services. Nevertheless, the high costs of the war veterans' pension scheme have not been properly addressed, leading to budget overruns. As a result, the otherwise successful 24-month IMF Stand-by Arrangement (SBA) expired in August 2017 without completion of the fourth review and disbursement of the final tranche. Low implementation of the commitments under the Stabilisation and Association Agreement (SAA) prevented Kosovo from fully benefiting from the increased trade access made possible by the SAA. The policy guidance jointly adopted in May 2017 has been partially implemented, while measures agreed under the European reform agenda have been delayed.

Macroeconomic Stability

Figure 7.1. Kosovo GDP growth



Source: Eurostat, Kosovo sources

Despite GDP growth of more than 4 % in the last 3 years, Kosovo remains the poorest economy in the region. Kosovo's GDP per capita was estimated to be around EUR 3 200 in nominal terms in 2017. Real growth remained strong, 3.9 % in the first three quarters of 2017 compared to 4.1 % in 2016, on account of strong road building and FDI financed investments. Net exports provided a positive contribution to growth, given that the largest metals exporter, Ferronikeli, regained lost Far East export markets and services exports rose sharply. Unlike in previous years, quarterly data shows private consumption contracting by 2.5 %, despite strong consumer lending, a high inflow of remittances, and a strong retail turnover, pointing to possible data inconsistencies. The supply side of GDP shows encouraging broad-based growth driven by construction, trade and the financial sector, while the public administration and other services activities decreased sharply. Overall Kosovo production capacities remain underdeveloped and the economy remains reliant on consumption, investment in infrastructure and remittances.

Stronger exports of services helped to narrow the external imbalances. The current account deficit shrank to 5.9 % of GDP in 2017, compared to 9.1 % of GDP in 2016. This was mainly due to the strong growth in services exports. Methodological changes in accounting for the economic activity of Kosovo's periodically returning diaspora could explain such a strong adjustment and the drop in private consumption mentioned above. The goods trade deficit increased by 1 percentage point to 38.9 % of GDP. An important source of revenue for many Kosovo households, remittances increased to 12 % of GDP in 2017. Net FDI increased to 3.9 % of GDP compared to 2.9 % of GDP in 2016). FDI inflows were even more concentrated in 2017, given that the share of real estate, construction and the financial sector FDI rose to 97.1 %. Inflow to the production sectors was negative. This reflects a weak business environment and few 'greenfield' investment opportunities.

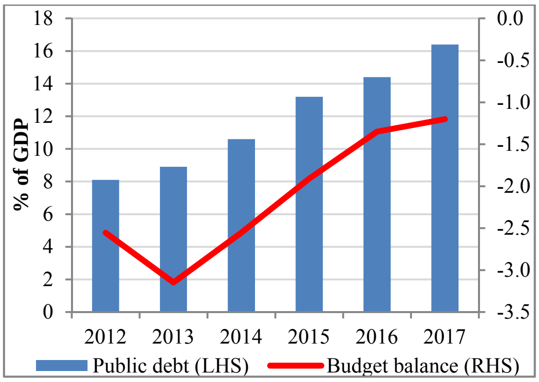
Table 7.1: **Kosovo - Main economic trends**

		2012	2013	2014	2015	2016	2017
Gross domestic product	Ann. % ch	2.8	3.4	1.2	4.1	4.1	3.7
Private consumption	Ann. % ch	2.9	2.0	4.9	3.8	4.8	-1.5
Investment	Ann. % ch	-12.9	-0.3	-5.0	11.3	7.5	10.9
Unemployment rate	%	30.9	30.0	35.3	32.9	27.5	n.a
Employment	Ann. % ch	n.a	11.8	-4.4	-8.2	11.8	n.a
Wages	Ann. % ch	n.a	n.a	n.a	n.a	n.a	n.a
Current account balance*	% of GDP	-7.5	-3.4	-6.9	-8.6	-8.3	-5.9
Direct investment (FDI, net)*	% of GDP	4.2	5.3	2.7	5.3	3.6	4.4
CPI, average	Ann. % ch	2.5	1.8	0.4	-0.5	0.3	1.5
Exchange rate EUR/EUR	Value	1.00	1.00	1.00	1.00	1.00	1.00
General government balance	% of GDP	-2.6	-3.1	-2.2	-2.0	-1.2	n.a
General government debt	% of GDP	8.1	8.9	10.7	13.1	14.6	16.6

** refers to a 4 quarters moving average.
Source: Macrobond, Eurostat

As a small economy with low domestic production, price developments in Kosovo are mainly driven by import prices of food and energy. Average consumer price inflation in 2017 rose to 1.5 %, compared with 0.3 % in 2016. Average import price inflation was 4.4 % in the first three quarters of 2017. Both price developments reflect movements in global food and fuel prices while core inflation remains low. On the other hand, producer price inflation was only 0.3 % in the same period mainly due to low wage growth.

Figure 7.2. Kosovo fiscal developments



Sources: Eurostat, Kosovo sources

Fiscal stability was preserved in 2016 and 2017 despite the lack of implementation of some important fiscal reforms. Strong economic growth and better revenue collection led to significant revenue growth of 9.4 % and 5.3 % in 2016 and 2017 respectively. Total expenditure also rose by 6.9 % and 4.9 % in the same period while the share of capital spending remained unchanged (26.9 % of overall spending in 2017. Capital spending was still under-executed due to overestimation of financing available from international financial institutions (IFI) and the Privatisation Agency. Furthermore, the weak collection of municipal revenue which is tied to execution of some small-scale capital projects delayed investments at the local level. Budget allocations for war veteran benefits were surpassed both in 2016 and 2017, due to the number of eligible recipients which was double the figure expected. To limit the cost of the war veteran pension scheme, a spending limit of 0.7 % of GDP was introduced. However it is to be applied only after a special commission reclassifies all eligible recipients according to the new stricter criteria. Due to the delays in the reclassification process, the IMF SBA expired without disbursement of the final tranche. In the 2017 budget revision an additional EUR 26.2 million were allocated to the war veteran pension, bringing the overall amount to 1 % of GDP.

Kosovo's public debt remained relatively low at 16.4 % of GDP([3]) in 2017 but is increasing. The average weighted interest rate continued declining to 1.92% owing to the large share of concessional loans from IFIs. The average maturity of domestic debt (20.2 months) is likely to continue increasing after Kosovo issued for the first time a bond with seven year maturity in August 2017. Government deposits increased in the last two years to 5.3 % of GDP, above the regulatory requirement.

The 2018 budget projects stable public finances but significant adjustments might be necessary in the midterm review. Forecasted total revenue growth (8.3 % compared to the 2017 preliminary results) will rely on significant broadening of tax base resulting from the fight against informality as no new revenue measures are planned in 2018. Starting in 2018 the wage bill growth will be limited to the growth rate of the last available nominal GDP (currently 4.3 %). Therefore the public wages will be increased by 4 % while the rest will be spend on new hiring. The amount allocated for various war veteran benefit programmes is likely to be insufficient unless the reclassification process also re-examines the certificates of existing recipients. The cost of the war veteran disability scheme could also increase beyond the budget allocation, as more than 3 000 new applicants await certification. The growth of capital spending (37.1 %) seems overly ambitious. Kosovo's capacity to absorb funds would have to significantly increase to reach the estimates of the IFI disbursement under the 'investment clause'. The deficit, according to the fiscal rule, is expected to be 1.7 % of GDP But the midterm review may very well transfer funds from the capital budget to finance increased social expenditures.

([3]) Not including Kosovo's share of the London and Paris club debt of the former Yugoslavia, currently estimated at around 6% of GDP.

Fiscal governance has made some progress but still faces significant challenges. While fiscal data is available, it is still not reliable, nor available on a timely basis. The capacity to make credible macroeconomic and budgetary forecasts remains low and they largely rely on IMF forecasts. However, the credibility of both the Medium Term Expenditure Framework (MTEF) projections and the budget estimates has improved. Partly as a result of increased realism in the projection of revenues, improved commitment controls and effective use of in-year budget reallocations, the deviations between forward-looking estimates and real revenues and expenditure were significantly reduced. Initial attempts have been made to involve the Budget and Finance Committee in discussions, but this practice is not yet systematic. Kosovo operates and complies with its own system of fiscal rules which aims to balance fiscal discipline and investment needs. The public accounting systems are covering most areas of income and expenditure and they are subject to internal control and independent audits.

Kosovo's unilateral euroisation makes maintaining macroeconomic and financial stability particularly relevant. Kosovo does not have standard monetary policy tools at its disposal, as it uses the euro as legal tender, leaving fiscal policy as the main macroeconomic policy instrument. Public debt is still low while current levels of international reserves are adequate and provide a buffer against external and liquidity shocks.

Functioning of product markets

Business environment

Significant progress was made in improving the business environment. An online system for filing and paying VAT and social security contributions was introduced, facilitating tax payments for businesses. The time it took to export and the cost of regulatory compliance in order to export were reduced as a result of the improved automated customs data management system, the streamlining of customs clearance processes and the implementation of the Albania-Kosovo transit corridor. Starting a business was made easier thanks to a web-based business registration system and a simplified process for registering employees. Access to credit was made easier with the adoption of clear priority rules in bankruptcy procedures for secured creditors. Resolving insolvency was made easier with the introduction of a legal framework for corporate insolvency. The new Law on Business Organisation will further simplify business registration procedures and introduce changes to the corporate governance.

Despite progress on the legal rules governing businesses many obstacles remain. In 2017 Kosovo was one of the top 10 reformers according to the World Bank *Doing Business* report. Nevertheless, the main obstacles to doing business still include a weak and unaccountable administration, weak rule of law, corruption and a widespread informal economy. Although informality remains high, around 30 % of GDP, different studies point to its continued decrease between 2013 and 2015 due to the improved effectiveness of tax administration practices. However, the black economy increased in absolute terms. The construction and trade sectors experienced the largest losses in revenue due to informality. The judicial system suffers from poor accessibility, inefficiency and delays. Little progress was recorded in clearing court backlogs of unresolved cases.

State influence on product markets

State aid and subsidies are still administered without a comprehensive strategy or a cost benefit evaluation. Public enterprises continue to receive government subsidies and grants with little impact on their profitability. Management appointment procedures continued to be subject to partisan political influence leading to prevalent mismanagement and delays in appointments. Tax exemptions for certain sectors were expanded but have had limited impact so far on exports and investment. The government continued to provide agricultural subsidies but the land consolidation process is not being implemented leading to low productivity gains for the sector. The Law on Strategic Investment has not yet had an impact on attracting investments. Financial support to the economic zones and industrial parks continued without a clear plan or a transparent impact or gap analysis. Government influence on price controls for utilities and postal and telecommunications services continued. The Public Procurement Review Body (PRB) could lose its quorum and become dysfunctional as two board members are facing corruption charges. Furthermore, the reported intimidation of members of the PRB undermines this important complaint mechanism reducing the transparency and credibility of the entire procurement process.

Privatisation and restructuring

The unresolved status of property rights and the lengthy legal proceedings in dealing with financial claims on privatised assets hinder the privatisation process. The government decided in November 2017 to temporary suspend the privatisation of socially owned lands. The feasibility study for the Trepça mining complex has been prepared. However the change in ownership structure to a shareholding company, as required by the law, has not been made due to government inaction and problems appointing the supervisory board. After not materialising in 2017, the disbursement of EUR 86 million from the Privatisation Agency has again been earmarked in the 2018 budget.

Functioning of the financial market

Financial stability

The financial sector remained well capitalised and with ample liquidity buffers. Regulatory capital to risk-weighted assets in the banking sector stood at 18 % in December 2017, above the regulatory minimum of 12 %. Credit risks are low, as the proportion of non-performing loans, which are fully covered by bank provisions, is the lowest in the region and fell further to 3.1 % by December 2017. This was due to stronger credit growth, strong economic performance and improvements in bankruptcy and insolvency procedures. The financial sector recorded high profitability in 2017. Return on average equity was 21.3 %, 17.6 % and 17.7 % for the banking sector, micro-financial institutions and the insurance sector respectively. The Central Bank of Kosovo has recently entered into a memorandum of cooperation with the European Banking Authority and with the European Insurance and Occupational Pensions Authority establishing a framework of cooperation and information exchange to strengthen the banking regulation and supervision of banks operating in the EU and in the south-eastern European countries.

Access to finance

Kosovo's financial sector still shows ample room for stronger banking activity. The largely foreign-owned Banking sector in Kosovo takes up 65.7 % of the total assets of the financial sector followed by the pension funds (28 %). Total assets in the banking sector had grown by 6.6 % in 2017, standing at 61.3 % of GDP. Lending activities accelerated compared to the previous year (11.5 % growth in total loans) supported by strong lending to households (12.7% growth). The loan-to-deposit ratio increased to 80.4 % from 76.9 % in 2016. The average interest rate on loans decreased in 2017 to 6.8 % from 7.5 % in 2016 but still remains above the regional average.

The insurance sector is weakly supervised despite improvements in transparency. The sector is dominated by non-life insurance companies. The cost of car insurance is artificially high, due in part to Kosovo not being a member of the 'green card' system, but also to it not having fully liberalised third-party liability insurance prices.

Functioning of the Labour market

Stable economic growth over recent years has only marginally been able to improve labour market conditions. Since 2016, the Kosovo Statistics Agency has been producing quarterly labour force survey (LFS) data. However, questions about the comparability of quarterly and annual series remain. According to the LFS, the labour participation rate and the employment rate increased in the first nine months of

2017 to 42.7 % and 29.7 % respectively, compared to 38.7 % and 28 % in 2016. At the same time, the unemployment rate increased to 30.4 % compared to 27.5 % in 2016 and Kosovo still has the highest unemployment and the lowest participation rate in Europe. The labour market outcomes for women are particularly weak (only 20.2 % of women participated in the labour market and 38 % of these were unemployed in the first 9 months of 2017). High youth unemployment (51.6 %) demonstrates a clear misalignment between education system outcomes and labour market needs (i.e. a mismatch between students' qualifications and skills and what is needed in the job market). This calls for more active labour market policies, pre-qualification schemes and vocational training programmes. By contrast, Kosovo does not have a problem with labour protection legislation, high taxation or a social welfare system which would disincentivise work, with the exception of untargeted war veteran transfers. Funding for employment services and vocational training remains insufficient and is fragmented across several entities. According to the Enterprise Structural Survey conducted by the Kosovo Agency of Statistics, the average monthly private sector wage in 2016 was around EUR 359, 1.4 % higher than in 2015.

Figure 7.3. Unemployment in Kosovo (% of Active population)

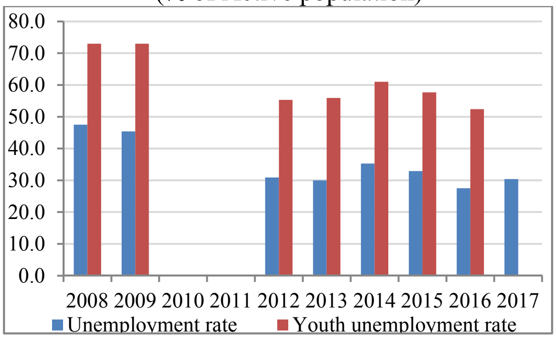
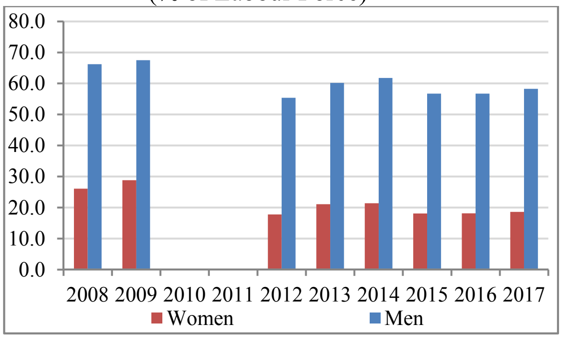


Figure 7.4. Participation rates in Kosovo (% of Labour Force)



Source: Eurostat, Kosovo sources

7.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURES AND MARKET FORCES WITHIN THE UNION

Kosovo has made **some progress** and is at an **early stage** in terms of capacity to cope with competitive pressure and market forces within the EU. No progress was made on improving the quality of education and addressing skills gaps in the labour market. Kosovo made some progress in improving road infrastructure but large infrastructure gaps in the railway and energy sectors remain. Structural changes in the economy are slow as it remains reliant on the trade sector. Integration with the EU is hampered by the slow implementation of the SAA.

In the forthcoming period, Kosovo should pay particular attention to:

→ addressing the mismatch between education outcomes and labour market needs leading to high youth unemployment;

→ improving the capacity of central and local government to prepare and manage investment projects;

→ securing a stable energy supply, reducing distribution losses in the electricity network and improving energy efficiency.

Education and innovation

The education sector is not properly aligned with labour market needs, resulting in low employability of graduates and a significant skills premium. Public spending on education remained unchanged at 4.6 % of GDP in 2016, which is broadly in line with middle income countries with similar age profiles. However, considering the relatively large number of students, Kosovo spends considerably less than some neighbouring countries per student in primary and secondary education. Furthermore, spending on education is dominated by the wage bill. Early childcare and pre-schooling enrolment rates are very low at 4.4 % and 33.9 % respectively, still well below the EU target of 95 % by 2020. In contrast there are relatively high enrolment rates in primary and secondary education, 96 % and 88.1 %, respectively. Enrolment at tertiary level is very high with 120,000 students in both public and private higher education institutions. However, low PISA scores and a high unemployment rate among higher education graduates (26.7 % in Q3 2017) indicate the poor quality of education in general and its misalignment with labour market needs. Given this situation Kosovo should work on developing closer cooperation between the education system and the private sector.

Spending on research is virtually non-existent. Kosovo needs to considerably increase investment in research and innovation (currently only 0.1 % of GDP), and establish links between academic institutions and the private sector. In September 2017, a new Ministry of Innovation and Entrepreneurship was established and tasked with supporting entrepreneurship and private initiatives through innovation, with a focus on the development of manufacturing and service SMEs.

Physical capital and quality of infrastructure

Kosovo made some progress in improving its physical capital, mainly for public road infrastructure investments. However, Kosovo's transport system is plagued by the weak administrative capacity of regulatory institutions and the poor state of infrastructure. Investments in road infrastructure are mainly focused on road repairs and the building of highways. In addition, investments in irrigation systems, the treatment of waste water, water projects, the upgrading health facilities, municipal public transport and the upgrading of the railway sector are being supported by donors. Rehabilitation of railway line 10, a key priority for the National Investment Committee, is the first project that will be implemented in line with the regional connectivity agenda.

The lack of regional connectivity in transport and energy security remains a bottleneck for the economy. An unreliable supply of energy remains one of the key obstacles to economic development. The inter-connection line between Albania and Kosovo – completed in 2016 – was still not functional late 2017 due to political disagreements with Serbia. Agreement on the construction of a new 500-megawatt lignite power plant has been reached and construction is expected to start in early 2019. The EUR 1.3 billion project will be financed entirely by the investor and should help to maintain a more reliable supply of electricity. High distribution losses in the electricity network and low energy efficiency further undermine energy security. The issue can be addressed by expanding energy efficiency incentives to the private sector and households. Since April 2017, energy producers are obliged to deliver all the electricity generated at deregulated prices, thus helping to open the electricity market. Electricity production from renewable sources is at a very low level despite attested potential for solar and wind energy exploitation.

The digitalisation of the economy has not progressed much over the past year. Kosovo is gradually aligning national legislation with the *acquis*, but implementation is lagging behind. An increased number of businesses are conducting e-commerce. However, exact data is yet to be published. The penetration rate of fixed broadband internet is expanding gradually from year to year, reaching 86.7 % during the first quarter of 2017 compared to 75.5 % a year before. In addition, the number of mobile phone users has increased to 112.14 % compared to 97.08 % a year before. The number of employees and the share of gross value added (GVA) of the ICT industry have gradually increased since 2008 but still remain low despite ample potential for stronger development.

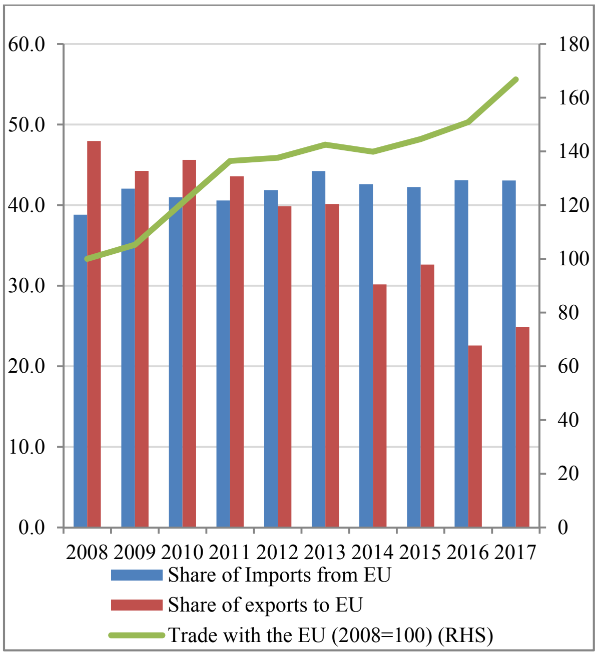
Sectoral and Enterprise Structure

There have been no significant structural changes in Kosovo's economy. Kosovo's private sector continues to be fragmented and unable to exploit economies of scale as micro enterprises dominate the economy. According to the Enterprise Structural Survey for 2016, the largest number of enterprises in Kosovo belongs to the trade sector (47.7 %), followed by business services and other services (13.6 %) and the processing industry (13.5 %). The total number of people employed in the private sector was 156 504, out of which: the trade sector accounts for 34.9 %; the processing industry 15.6 % and business services 11.8 %. The largest share of total business turnover was in the trade sector with 57.5%, followed by the processing industry 11.9 % and construction with 10.5 %. The structure of the GVA in Kosovo has not significantly changed over the recent years except for a noticeable downward trend in the share of agriculture, which continued in 2016, (to 13 %). The shares of mining, manufacturing, construction and services, continue hovering around their long term averages.

The Kosovo Credit Guarantee Fund meant to provide credit guarantees for private investment is fully operational. The Fund has granted 785 of loans for local businesses with an approved loan amount of EUR 29.5 million. The government has committed to providing additional funding in 2018 to strengthen the Fund's capacity to guarantee credit.

Economic Integration with the EU and price competitiveness

Figure 7.5. Kosovo trade integration with the EU



The Stabilisation Association Agreement's contribution to increasing trade was hampered by the slow implementation of necessary reforms. Kosovo's economy is still relatively unintegrated in global trade flows, with a trade openness of 74.5 % of GDP despite a 10.6 % rise in total trade of goods and services in 2017. Most of Kosovo's exports still consist of basic raw materials and mineral products, reflecting limited diversification of the Kosovo production sector. However, in 2017 there was a significant increase in exports of manufactured goods, agriculture products and processed food. The EU continued to be Kosovo's biggest trading partner with 41 % of the overall trade in 2017, followed by the CEFTA([4]) countries with 30.3 %. Despite a 30.1% growth in exports to the EU, Kosovo's trade deficit with the EU further widened in 2017. The development of a Regional Economic Area based on EU rules and standards, to which all Western Balkan economies have committed, has the potential to generate so far untapped growth. The EU remains the main investor in Kosovo with 46.4 % of the overall inflow of FDI in 2017.

([4]) The Central European Free Trade Agreement

7.3. CONCLUSIONS

As regards the economic criteria, Kosovo has made good progress and is at an early stage of developing a functioning market economy. The business environment has improved and the government adhered to the fiscal rule on budget deficit; however, war veterans' benefits continue to pose a challenge for public finances. The informal economy remains widespread. The increase in the labour force participation rate was not matched by gains in employment so the unemployment rate increased further. It particularly affected women and young and unskilled workers. Despite strong export growth the high trade deficit reflects a weak production base.

Kosovo has made some progress and is at an early stage in terms of capacity to cope with competitive pressure and market forces within the EU. No progress was made on improving the quality of education and addressing skills gaps in the labour market. Kosovo made some progress in improving road infrastructure but large infrastructure gaps in the railway and energy sectors remain. Structural changes in the economy are slow as it remains reliant on the retail trade sector. Integration with the EU is hampered by the slow implementation of the SAA.

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